A STUDY OF EXECUTIVE COMPENSATION VERSUS STOCK PERFORMANCE IN THE FINANCE INDUSTRY

by

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ABSTRACT

Executive compensation has become a significant political, academic, and corporate concern in the wake of the 2008 government bailouts of large financial institutions (Mason-Draffen, 2008). Previous research indicates there may be a connection between compensation and corporate performance (Jonas, 2007). This quantitative, ex post facto research study sought to describe any relationship between annual executive compensation and end-of-fiscal-year financial share price through a correlation analysis of top-executive compensation and Fortune 500 financial industry company stock performance over a five-year period (2003-2007). The results of this study revealed a non-significant relationship between executive compensation and share price using a Spearman's Rho analysis of the top five compensated executives and annual stock price. The author recommends compensation committees follow a BAKE strategy when managing executive compensation practices. The acronym *BAKE* refers to benchmarking against other companies, aligning compensation to organizational goals, keeping track of executive compensation strategies, and periodically evaluating the compensation plan. Formalizing and adding additional rigor to the process of executive compensation management in financial companies may provide for stronger defense against potential profit-damaging government or activist shareholder-initiated compensation restrictions.

DEDICATION

This work is dedicated to my loving wife, Kristin, without whom I would have never had the strength to finish. Her patience was astounding and held me accountable to my goals.

I also dedicate this work to my grandfather, Ken, whose example continues to provide motivation for the furthering of my career both educational and beyond.

To my parents, C. K. and Jenny, thank you for your support throughout the process and for never letting me think it was possible to fail.

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CHAPTER 1: INTRODUCTION

Executive compensation has become a significant political, academic, and corporate concern in the wake of the 2008 government bailouts of large financial institutions (Mason-Draffen, 2008). Compared with average employee wages, executive compensation has risen significantly throughout the 1980s, 1990s, and early 21st century (Anderson, Cavanagh, Hartman, Klinger, & Chan, 2004). The ratio of Chief Executive Officer (CEO) compensation to average employee salary in the early 1980s was 42:1, and this grew to 301:1 by 2003 (Anderson et al., 2004). In January 2010, *The Wall Street Journal* reported that major United States (U.S.) banks and securities were set to pay approximately $145 billion in wages, bonuses, and other benefits for 2009, representing an 18% increase over the prior year (Grocer, 2010). Historically, business has cited increased performance and increased stress as reasons for this gap (Gordon, 1940).

The increase in relative wages, along with the increased focus of company stakeholders on short-term, as well as long-term, performance presents a significant opportunity for research. The topic of this dissertation is the study of the relationship between executive compensation and corporate stock performance within the finance industry. The information obtained from this study will be used to help corporate compensation committees determine appropriate compensation levels, as well as to provide a basis for further research, and as a basic understanding firms can leverage to plan long-term compensation strategy better.

The first chapter of this study is organized to provide the reader with an understanding of the problem and the significance of the study. The first section describes the central problem of the study. The next sections describe the purpose of the study both to the academic community and to current practitioners. The final sections of Chapter 1 provide a basic understanding of the planned testing methodology, as well as the theoretical framework used in the design of the study.

Background of the Problem

Executive compensation is a complex issue, and many studies and opinions disagree on what the most accurate and descriptive theory is (Crumley, 2006). Previous research indicates there may be a connection between compensation and corporate performance (Jonas, 2007). Executive compensation in the financial industry has been disputed as disproportionate to overall company performance (Crawford, 1999; McGregor, 2009; Taleb, 2009; Wright, 2009). Historically, agency theory has been the most prominent theory describing the usage of compensation strategies by organizational stakeholders to influence management decision-making, while others have suggested that contract theory, marginal productivity theory, labor theory, and others also influence executive compensation decision-making and strategy (Morlino, 2008; Roberts, 1956).

In the early 20th century, executive management was compensated based on production output and its perceived value to the organization (Taussig & Barker, 1925). Throughout the middle of the 20th century, corporations became more adept at understanding differences in compensation's motivating effects on different demographic groups (Foote, 1971). Young executives often have significant fixed expenses, such as cars, homes, and other debt, making them less likely to seek significant compensation based on company performance, while more seasoned executives find company performance-based compensation appealing due to the high reward and increased challenge (Foote, 1971; Gordon, 1940).

Organizations benchmark compensation with similar firms within the industry and establish company goals and metrics (Cadman, Carter, & Semida, 2009). Firm size is consistently shown to have a significant correlation to compensation levels of executives. Larger organizations increase the number of assets and transactions, and the scope of responsibility for CEOs and top executives, thereby increasing executive compensation levels (Cadman et al., 2009; Veliyath, 1999). Despite conflicting theories, Vieto, Khan, Cerqueira, and Brandão (2008) observed that firms that are more profitable are found to pay their executives higher compensation packages. Additionally, many organizations use tournament-style compensation systems, in which executive levels are compensated significantly higher than the median

salary in an effort to provide increased incentive for lower-level employees to perform (Lee, Lev, & Yeo, 2008).

Finance Industry

According to the U.S. Bureau of Labor Statistics (BLS, 2009), the finance industry is composed of banking, financial planning, investments, and insurance. Financial organizations may provide business-to-business services, as well as consumer products. The finance industry is considered a service industry regulated by state, federal, and international regulations (BLS, 2009). Within the U.S., finance employees are educated with undergraduate and graduate degrees, contributing to an increased median income compared with many other industries, and are generally compensated by annual salary, commission, or a combination of the two. The 2008 median wage, including bonuses, for business and financial operations was $64,720 (BLS, 2009).

Changing Environment

Over the past 25 years, the gap between CEO compensation and average employee wages has risen from 420% more than the average employee's wages to 3,001% more than the average employee's wages (Anderson et al., 2004). The projected financial industry compensation for 2009 of $145 billion represents an increase of 18% over 2008 compensation levels and a 6% increase over 2007's record-setting compensation levels (Grocer, 2010). The U.S. has enacted several laws and regulations governing executive compensation as the ratio of executive pay to line-employee pay has increased (Anderson et al., 2004). These regulations primarily focus on the visibility of executive earnings to stakeholders. The 2002 Sarbanes-Oxley Act requires publicly traded companies to disclose their top five earning executives and their salaries (Lawler, 2009). The complexity of many executives' compensation packages has led to additional regulations requiring executives' compensation packages to be described further in simple and less confusing terms (Lawler, 2009).

New legislation, such as the 2009 Fair Pay Act, increases the potential liability an organization may face because of differences in executive compensation for women and minorities, further requiring organizations to publicize and benchmark executive compensation practices (Grant, Grant, & Tibus, 2009). Compensation within the financial industry has become even more significant as a topic of academic and practitioner interest after the events of the 2008 financial crisis, with many researchers believing risky business practices were taken, in part, due to compensation practices rewarding short-term risk-taking behaviors over long-term strategies ("Make them Pay", 2008).

Engagement and Retention

A body of compensation research describes how compensation affects executive morale, engagement, and retention (Heyle, 2007; Medlin & Green, 2008). Fully engaged employees and managers provide increased productivity to the organization, as well as increased levels of total company morale (Mastrangelo, 2009). A high level of executive retention has the potential for positive effects on the overall performance of the organization.

Burchman and Jones' (2008) review of current compensation trends indicated that companies are focusing on the retention of key executives and managers using bonuses, providing guaranteed compensation for executives during economic or performance downturns. The use of retention bonuses increases the ability for companies to retain top talent by reducing the incentive for talent to jump from company to company based on the company's prior bonus performance (Burchman & Jones, 2008). Executive bonuses awarded to financial industry executives are oftentimes significantly higher than the average U.S. citizen's wages. Proponents of increased regulation cite the significant bonuses paid out to executives despite corporate failures as a sign that bonus plans, in fact, were not increasing firm performance (McGregor, 2009). After the events of the 2008 financial crisis, companies receiving Troubled Asset Relief Program (TARP) benefits, such as AIG, issued retention bonuses to their executives and managers. These bonuses ranged from hundreds of thousands to millions depending upon the employee's level and contribution. The oversight organizations quickly rebuked the financial

organizations and forced the TARP recipients either to scale back or to defend their employee bonus awards. Many of the TARP-funded organizations defended their bonus awards as a customary and necessary practice to retain talent and reward employee performance. In some cases, bank employees received significant bonuses, while the bank itself reported significant financial losses (McGregor, 2009; Taleb, 2009; Wright 2009).

Statement of the Problem

Traditionally, organizations attempt to compensate executives based on how the executives affect the overall organization (Gordon, 1940). For organizations, there is the potential for compensation not to align with overall company performance (Johnson & Natarajan, 2005). Executive compensation in the financial industry has been disputed as disproportionate to overall company performance (Crawford, 1999; McGregor, 2009; Taleb, 2009; Wright, 2009). A misalignment in executive compensation compared with company performance may represent diminished overall corporate profitability and an opportunity for decreased shareholder value (Johnson & Natarajan, 2005). The problem is that over the past 25 years, the gap between CEO compensation and average employee wages has risen from 420% more than the average employee's wages to 3,001% more than the average employee's wages (Anderson et al., 2004).

This quantitative, ex post facto research study describes any relationship between annual executive compensation and end-of-fiscal-year financial share price through a statistical analysis of publicly available data on top-executive compensation submitted to the Securities and Exchange Commission (SEC), and Fortune 500 financial industry company stock performance. Understanding the relationship executive compensation has with organizational performance may aid the leadership community in further developing executive compensation theory.

Purpose of the Study

The purpose of this research study was to describe any relationship between annual executive compensation and yearly average financial share price through a statistical correlation analysis of publicly available data submitted to the SEC by Fortune 500 financial industry companies. The reviewed sample population included a random selection of Fortune 500 financial industry companies. Differences in executive compensation as defined by the compensation disclosed in corporate proxy statements were compared against overall company performance as measured by company stock price over a 5-year period from 2003 through 2007.

The key variables for this study were executive compensation and average share price performance. The independent variable in the study, executive compensation, included wages, bonuses, health and welfare benefits, stock options/awards, and additional benefits, such as corporate travel. The dependent variable was the end-of-year stock price of the organization for each of the reviewed periods.

Corporate performance, as well as the top five executive compensation rates for each company (as listed in each company's proxy statement), were measured through each financial company's SEC-filed 10K reports, financial statements, and proxy statements. A statistical correlation analysis was performed to determine to what extent, if any, top-level executive compensation level correlates to organizational performance as measured by changes to the sampled companies' share prices.

Significance of the Problem

Understanding the relationship executive compensation has with organizational performance may aid the leadership community in further developing executive compensation theory. This study provides the academic community with insight into how compensation of executive leadership in the finance industry affects company performance. Employee salaries and related compensation expenses are often one of the most significant expenses a financial services organization has on its income statement (Jensen, Stark, & McMullen, 2008).

Significance of the Study

Understanding what effect executive compensation has on organizational performance may help practitioners adjust their operational strategy. With the increased focus on executive compensation after the 2008 financial crises ("Make them Pay", 2008), the finance industry faces the potential for government analysis and involvement in determining compensation levels for key executives ("Better Pay for All," 2007). Further research on the effects of executive compensation on motivating and retaining key executives, as well as the correlation between compensation and company performance, is needed to provide greater understanding of the potential benefits or detriments of increased compensation regulation.

Significance of the Study to Leadership

The study of executive compensation on corporate performance provides further evidence of the effects leadership motivation has on corporations. Corporate stakeholders in the finance industry, particularly company directors and stockholders, may use the results to evaluate the leadership compensation practices of their organizations. Additionally, the results of this study may be used to help predict the effects executive compensation will have on organizational performance in other industries with compensation benchmarking.

Nature of the Study

This section of the study provides an introduction to the research method and design of the study. An inappropriate or impractical research design may inadvertently influence the results of the study or increase doubt in the study's overall findings (Creswell, 2002; Neuman, 2004). A more detailed review of the research design and methodology is included in Chapter 3.

Overview of the Research Method and Design Appropriateness

This research study describes any relationship observed between annual executive compensation and end-of-year fiscal year financial share price by analyzing publicly available Fortune 500 financial industry companies data submitted to the SEC. A qualitative research design is not appropriate because the results of a qualitative research design cannot be extrapolated across a population (Creswell, 2002; Neuman, 2004). Prior studies (Jonas, 2007) have identified the variables of executive compensation and company share price. A qualitative research design identifies and describes variables but cannot definitively describe relationships between variables within a system (Creswell, 2002; Neuman, 2004). A quantitative, ex post facto study provides a view of historical trending that can be used in the development of models predicting future outcomes. The availability of the data, as well as the clear identification of the variables, makes a quantitative, ex post facto study best suited for the purpose of this study (Creswell, 2002; Neuman, 2004).

Sample Selection

This quantitative, ex post facto correlation research study reviewed a sample of Fortune 500 finance industry companies' share performances and their associated top five compensated executives as reported by the company to the SEC. Based on the abundant availability of data, a random sample of all publicly traded Fortune 500 financial industry companies will be selected with a 99% confidence level using an interval of five.

Publicly traded organizations are necessary for this study, because private organizations will not have traded shares or publicly available compensation data. A random sample provides for extrapolation of results across the entire population. A sample size of five executives from each organization was selected based on the public availability of the top five executive compensation data for publicly traded companies within the U.S. The top five compensated executives represent an appropriate sample based on their status as the top earners for the organization, including the CEO and the Chief Financial Officer

(CFO). Performance metrics were obtained from company historical share price performance as listed on the New York Stock Exchange (NYSE) or another relevant stock market exchange at the company's fiscal year end, to tie with executive yearly bonus structure metrics. Share price constitutes the annual average share price for each organization reviewed. Five annual data points were used (2003–2007), and the five-year period is based on the availability of the data, as executive compensation data were not publicly available for publicly traded companies prior to 2002. Five years of financial share price performance provides enough data points for the observation of both performance and compensation trends.

Data Collection Method

This quantitative, ex post facto correlation research study used secondary data sources for both share price data and executive compensation data for the sampled Fortune 500 companies. Share price data, including average share price per year for each of the sampled companies, were obtained from historical MarketWatch data for each of the sampled five years. Executive compensation data for each of the sampled companies and sampled years were obtained through the Electronic Data Gathering Analysis and Retrieval System (EDGAR) of historical SEC 10K filings. Data from both MarketWatch and EDGAR are considered reliable within the U.S. financial system (Jonas, 2007).

Data Analysis and Data Presentation

Data in this quantitative, ex post facto correlation research study were analyzed using bivariate descriptive and inferential statistics. Descriptive statistics were used to describe the variability in participating organizations' executive compensation and stock prices. Spearman's Rho was used to determine if there was a significant relationship between executive compensation and stock prices for the participating Fortune 500 companies. The significance level was set at $p < .05$ for the correlational analysis. Results are presented in the form of charts, figures, and tables in Chapter 4.

Research Question

The purpose of this quantitative, ex post facto correlation research study was to help leadership determine the existence or non-existence of a correlation between executive compensation and annual average share price in Fortune 500 financial companies. The research question is then:

RQ1: What is the correlation between executive compensation and share price in Fortune 500 financial companies?

Hypotheses

Due to the quantitative research question posed in this study, the following null and research hypotheses were developed from research question RQ1:

H1O: There is no correlation between executive compensation as measured by cash, cash equivalents, and non-cash compensatory awards and publicly traded, New York Stock Exchange-listed, corporate share price movement from 2003 through 2007 in Fortune 500 financial companies.

H1A: There is no correlation between executive compensation as measured by cash, cash equivalents, and non-cash compensatory awards and publicly traded, New York Stock Exchange-listed, corporate share price movement from 2003 through 2007 in Fortune 500 financial companies.

A correlation between executive compensation and share price in Fortune 500 financial companies would indicate a likelihood of increased or decreased share performance in organizations with differing levels of executive compensation (Jonas, 2007).

Theoretical Framework

Total executive compensation comprises, in general, four distinct compensation methods: base fixed salary, annual bonus, stock options and restricted stock grants, and long-term incentive plans (Matsumura & Shin, 2005; Murphy, 1999). The purpose of executive compensation is to attract and

motivate talented individuals capable of performing the leadership function within the organization (Gordon, 1940; Johnson & Natarajan, 2005; Jonas, 2007).

Agency Theory

The primary support behind the current system of executive compensation has been agency theory (Donaldson & Davis, 1991; Matsumura & Shin, 2005). Agency theory states that employees of an organization will not perform effectively or in their employer's best interests unless their compensation is tied to the same goals the employer has or unless the employee is also in part an owner (Matsumura & Shin, 2005). The organizations' compensation committees on their board of directors execute agency theory compensation decisions. The board of directors is responsible for formally establishing and recording shareholders' organizational performance goals (Laux & Laux, 2009). The board (or compensation committee) then establishes the metrics used to measure goals and the methods used to tie compensation to company performance. Storero and Stephenson's (2009) article noted compensation governance issues at GE and Disney, in which the compensation committee and shareholders were not completely aware of the total costs associated with compensation elements. GE's ex-CEOs' expenses totaled over $2.5 million after just the first year, and Disney paid out millions in severance for a CEO who was only with the company for a few months. Wilson (2003) cites many corporate failures, including WorldCom and Enron, as examples in which agency theory did not protect shareholders' investments.

Absolute Versus Relative Compensation Metrics Models

Many companies choose to establish their company performance and compensation metrics using either an absolute or relative metrics model (Schubert & Barenbaum, 2009). Absolute models base equity-based compensation on performance indicators of the firm, such as share price. The higher the share price, sales, or market share grows, the more equity shares the executive earns. The motivation is based on the performance of the company in alignment with the shareholders. Relative models base

executive equity-based compensation on the performance of those same key performance indicators, but in relation to their ranking against his or her competitors (Schubert & Barenbaum, 2009). Relative models provide incentives for executives, eliminating concern for industry-specific circumstances. Poor or positive economic times become less of an issue compared with the performance of the executive team (Schubert & Barenbaum, 2009).

Compensation committees may also benchmark compensation practices against other organizations within the industry or organizations of similar size (Cadman et al., 2009). The board executes procedures to measure company performance and to determine when executives achieve the stated objectives throughout the pay cycle once the compensation committee has established and approved executive compensation criteria.

Earnings Management Theory

As organizations increase the percentage of pay-for-performance compensation elements in executives' total compensation schemes, there is a greater risk of executive fraud or earnings management (Laux & Laux, 2009). The counter to the increased risk of earnings management is the increased scope of audit committee review. The audit sub-committee of the board of directors is responsible for ensuring management is performing its function within the guidelines and procedures outlined by the board (Laux & Laux, 2009). The audit committee evaluates the work of internal and external company auditors to determine the accuracy of management reporting and the ethical standards of management and ensures the management of company assets is in line with shareholder expectations.

Organizational Size Compensation Theory

Research conducted by Veliyath (1999) and Cadman et al. (2009) suggested organizational size is the key variable driving executive compensation levels. Vieto et al. (2008) evaluated the executive compensation plans across different-sized Standard & Poor's (S&P) traded corporations over a 13-year period to determine any commonality or differentiation. There were notable differences in how each size

of organization compensated its executives. As the scope and scale of executive responsibility increases through organic growth, acquisitions, or corporate partnerships, executives are rewarded with increased compensation packages. Compensation based on organizational size provides a competing theoretical framework with traditional agency theory. In competitive industries, executives may be better served by acquiring a competitor rather than by improving actual long-term company performance (Harford & Li, 2007). Capital spending on long-term value-added projects may not represent the short-term compensation interests of executives when compared with the near immediate benefits associated with acquiring smaller competitors.

Wilson (2003) argued that the majority of financial compensation benefits are made without true insight into what most clearly motivates the individual. Matsumura and Shin (2005) noted that many compensation critics believe top management's compensation is not tied enough to the firm's performance or the benefit to shareholders. These critics argue that an executive team's lack of ethical management practices is because of agency theory failures (Schubert & Barenbaum, 2008). They observe that the standard solution of providing more compensation in the form of executive stock ownership might only further increase the ethical issues displayed by executives (Schubert & Barenbaum, 2008). Shareowners have just as many positive incentives to perform earnings management techniques. Further, share ownership raises several accounting concerns that may allow organizations to shield the true cost of executive compensation from shareholders.

Motivation/Engagement Theory

Motivation, or engagement, of employees provides measurable performance improvements for organizations, as well as increases the level of total-company morale (Mastrangelo, 2009). This form of manager and executive compensation structure can have a significant effect on the engagement and performance of company leaders. Shahzad and Bhatti's (2008) study evaluating the effects of financial and non-financial compensation on employee motivation indicated that compensation provides the most motivation and influence on performance when using social pay versus variable and indirect pay. Even

differences in equity-based compensation strategies can have a measurable effect on executive motivation and retention. Chen (2004) found that CEOs of organizations allowing stock incentives to be re-priced are more motivated than CEOs of organizations with strict no re-pricing policies. Firms with no re-pricing policies rely on the limited value of the stock options in negative performing years as an incentive for performance; however, this may incentivize executives to leave the organization should they believe economic conditions or other variables outside of executive control would negatively affect share price.

Definition of Terms

The definitions described in this section provide clarification of terms used throughout the study. The definitions have been provided specifically to clarify terms and variables related to leadership and business.

CEO. The CEO is the top-level leader of a corporation (Crawford, 1999).

Executive. Executives are top-level corporate organizational leaders (Foote, 1971).

Executive Compensation. Executive compensation includes cash salary, stock options or awards, health and wellness benefits, insurance, self or family education, company-provided housing, meal allowances, entertainments, and company-provided transportation (including car, plane, or yacht) given to executives for services rendered to the corporation (Bogle, 2008; Burchman & Jones, 2008; Foote, 1971; Jonas, 2007).

Share Price. Share price represents the value of one share of equity ownership for a given organization (Gordon, 1940).

Assumptions

Several assumptions are relevant to this study. First, this study assumes that corporate financial statements, 10K reports, and issued proxy statements are accurate and compliant with SEC and NYSE requirements. Second, this study assumes that financial organization share price on the NYSE financial market can be affected by changes in executive compensation. The study's third assumption is that the

Sarbanes-Oxley Act of 2002 increases the accuracy of reported executive compensation within the finance industry.

Scope and Limitations

The study represents a narrow focus on executive compensation and share price for publicly traded Fortune 500 finance industry corporations within the U.S. The study is limited to compensation and share price data from after 2003 because of the limited availability of reliable executive compensation data prior to the implementation of the Sarbanes-Oxley Act of 2002. Differences in corporate cultures and specific industry sub-type organizations may skew the results. The random selection process and high confidence level of the sample selection process reduce the effects of industry subtype or organization specific compensation or share price differences.

Delimitations

Delimiters come into play when exploring the relationship between executive compensation and corporate stock performance. The study evaluates publicly traded companies and their executives in Fortune 500 companies. Nonprofit and government agencies and private companies are not required to make financial statements to the SEC and potentially have different performance metrics and goals when compared with publicly held corporations. Similar studies, such as those conducted by Jonas (2007) and Nastasecu (2009), indicate there are differences in the compensation structure and components between public, private, and nonprofit organizations, particularly in the use of equity compensation. Many private companies measure success based on the resale value of the organization within a pre-defined period, rather than on short and long-term share price performance.

Intervening variables may increase or decrease the effect of compensation practices on an organization's financial performance. The complexity of human and environmental variables is such that it is practically unfeasible to account for all such factors in a standard operating environment. CEO and executive compensation may be affected by legal, industry, and organizational specific factors.

Organizational performance may be measured with differing metrics and strategies. The study reduces variability through a focus on the compensation practices and performance of a single industry.

Summary

Chapter 1 provided an overview of executive compensation and the theoretical framework used in developing this study. The purpose of this quantitative, ex post facto correlation research study is to describe any relationship between annual executive compensation and end-of-fiscal-year financial share price by analyzing publicly available data submitted to the SEC by a sample of Fortune 500 financial industry companies from 2003 through 2007. Understanding the relationship executive compensation has with organizational performance may aid the leadership community in further developing executive compensation theory (Jonas, 2007) and better managing one of the highest expense lines in an organization (Jensen et al., 2008). Significant theories related to executive compensation include agency theory, motivation and engagement theory, organizational size theory, and absolute versus relative performance theory (Cavalluzzo, Cavalluzzo, & Wolken, 2002; Donaldson & Davis, 1991; Jensen & Meckling, 1994/2001; Matsumura & Shin, 2005).

Chapter 2 includes a thorough review of applicable literature using germinal and recent research studies. The purpose of the literature review is to provide an understanding of historical and current executive compensation research, providing a framework for the research study within the literature.

CHAPTER 2: REVIEW OF THE LITERATURE

The topic of this dissertation is the study of the relationship between executive compensation and corporate stock performance within the finance industry. The study will increase academic understanding of how executive compensation is tied to corporate performance within the finance industry. It will also help industry leaders and shareholders to design, manage, and establish compensation structures better in future years.

A thorough review of applicable literature was performed using seminal and recent research studies. The purpose of the literature review is to provide an understanding of historical and current executive compensation research validating the need for the study.

Title Searches, Articles, Research Documents, and Journals

The literature review was developed primarily through research using peer-reviewed and industry-relevant publications within the leadership, finance, human resources, and general business fields. Significant database resources included ProQuest, Gale PowerSearch, and EBSCOhost online databases. Keyword and phrase article searches included executive compensation analysis; compensation and motivation; compensation and engagement; compensation components; compensation and retention; compensation and performance; compensation and share price; compensation measurement; compensation trends; compensation regulation; compensation history; compensation theory; executive bonus; bonus regulation; and government compensation regulation.

A number of journals were reviewed as part of the literature review. Significant journals referenced included *Managerial Finance*; *Strategic Finance*; *Journal of Finance*; *Economic Quarterly*; *Quarterly Journal of Economics*; and *Journal of Finance and Accounting*. Additionally, public business publications, such as *The Wall Street Journal*, were reviewed to provide an understanding of current political and social factors affecting the study of leadership and compensation.

Literature Review

The literature review begins with a review of executive compensation components and historical compensation practices, followed by recent theories arranged in order of an employee's experiences – engagement with the job, retention to stay, and compensation for success – and ends discussing recent events and issues related to executive compensation. To develop a thorough understanding of executive compensation, engagement, and retention, article reviews were completed that reviewed studies of executive compensation, executive and manager engagement, executive retention, and compensation practices within the finance industry. In this chapter, significant themes within the literature are highlighted, along with opportunities for new or additional research.

Executive Compensation Elements

Executive compensation comprises all financial and non-financial benefits provided to executives for their leadership and work practices at an organization (Bogle, 2008; Burchman & Jones, 2008; Foote, 1971; Jonas, 2007). Components of a modern executive compensation package include cash salary; stock options or awards; health and wellness benefits; insurance; self or family education; company-provided housing; meal allowances; entertainments; and company-provided transportation, including car, plane, or yacht (Bogle, 2008; Burchman & Jones, 2008; Foote, 1971; Jonas, 2007). These components can be broken down into three significant categories. The first category is direct cash compensation. Direct cash compensation includes executives' salary, health and wellness benefits, additional insurance, and cash bonus awards issued monthly, quarterly, or on an annual basis. Equity compensation is the second compensation category. Equity awards may be in the form of stock options, discounted stock purchases, restricted or preferred stock grants, direct partnership or ownership awards, as well as common share grants and are often the largest compensation component when awarded at full value containing the most significant tax and accounting treatment considerations. The third compensation category covers all compensated discretionary spending items. These items include company paid-for travel, meals, office

furniture, entertainment, and other expense account items. Discretionary spending items are inherently the hardest to value, and are the least likely of the three compensation categories to be determined accurately as actual compensation, as opposed to another business expense.

Engagement

Engagement is defined as the level at which an employee or agent is motivated to enhance the organization (Medlin & Green, 2008). Compensation is a critical component in increasing employee engagement and retention (Gagné & Forest, 2008; Gunn & Gullickson, 2007). Differing compensation criteria, such as variable versus fixed pay, performance appraisals, justice perceptions, organizational culture, work climate, needs satisfaction, and individual versus group incentives can affect employee and leadership engagement. Herpen, Praag, and Cools (2005) reviewed the relationship between pay and performance. The results indicated that the perception of the executive's compensation package contributes to extrinsic motivation, whereas intrinsic motivation is most affected by promotion opportunities, rather than the compensation structure. Fairness and transparency in the compensation structure contributes significantly to its motivational effectiveness.

Motivational theories, such as acceptance theory, help describe the expectations individuals may have regarding executive compensation (Barnard, Jeffrey, & Hazy, 2006). Acceptance theory is based on the idea that agents of the organization perform and serve the organization when the rewards for their effort are greater than the sacrifices caused by their relationship with the organization. Extrapolation of this theory leads to the conclusion that leaders will perform only when they are compensated based on the sacrifices they make to attain and hold that role. Leadership positions in large organizations take up considerable time and energy. It is therefore necessary for those positions to take a larger share of the organization's rewards (Barnard et al., 2006).

Shahzad and Bhatti's (2008) study evaluated the effects of financial and non-financial compensation on employee motivation. The results indicated that compensation provided the most motivation and influence on performance when using social pay versus variable and indirect pay.

Managers were most productive when their pay was increased over their peers' related to their performance. Medlin and Green's (2008) study of the relationship between goal setting, employee optimism, and engagement provided evidence that employee goal setting positively correlates to employee engagement. Additionally, the study showed that employee engagement predicts workplace optimism, and that in turn influences individual performance; thus, increasing employee engagement increases overall individual performance.

In a 664,000 participant research study conducted by International Survey Research, an employee research and consulting firm, ISR found that there was a significant relationship between employee engagement and business results ("Employee engagement boosts bottom line", 2006). The study found that highly engaged organizations reported almost 52% higher operating incomes compared with low-engagement organizations. The study also found that organizations with high engagement (organizations in the top half of the sample results) improved operating income by over 19% and earnings-per-share growth by almost 28%, whereas low-engagement organizations (organizations in the bottom half of the sample) showed almost a 4% decline in operating income and an 11% decline in earnings-per-share for the same period ("Employee engagement boosts bottom line", 2006).

Although the majority of scholars and practitioners agree that increased employee, manager, and executive engagement is a boon to organizations, Mastrangelo (2009) described an issue in the study of engagement related to the accuracy of engagement measurement. Mastrangelo's research on engagement suggested that the professional community needed to decide what exactly high engagement looks like. The wording of engagement questionnaires, as well as management's purpose in performing the organizational engagement survey, may provide inaccurate or at least less-than-useful data. Richman, Civian, Shannon, Hill, and Brennan (2008) found that employees displayed higher engagement when they perceived the organization was flexible with their personal situations. Formal flexible work processes were significantly more beneficial to the employee's perception of organizational flexibility than comparable occasional-basis flexible programs.

Marginal Utility of Compensation

Marginal utility of compensation can be described as the increase in utility for an individual or group for each additional unit of compensation (McConnell & Brue, 2005). Utility is an economics term for the degree at which a phenomenon satisfies a particular individual or group want or need. The degree at which increased compensation motivates executives is critical to the foundation of key compensation theories, such as agency theory (Tichy & Devanna, 1990). The resourceful, evaluative, maximizing model (REMM) of behavioral theory states that individuals take actions to maximize their wealth and happiness (Cavalluzzo et al., 2002; Jensen & Meckling, 1994/2001). Individuals' resourcefulness creates innovative and unique solutions to achieve goals, financial or otherwise. Those individuals evaluate their decisions and options to determine the most appropriate actions that will result in increased happiness. This model implies that an individual will look at all alternatives objectively and take actions that maximize the chance of achieving their personal desires. The REMM model is useful in determining the likely decision process of customers, employees, and other stakeholders (Cavalluzzo et al., 2002).

A review of the literature showed that compensation elements, such as money, have been connected to performance motivation. Companies provide increases in compensation according to responsibility level and work performance (McConnell & Brue, 2005). Researchers do note that motivational theories, such as Maslow's (1954) hierarchy, describe lower-order needs as satisfied by money, with more advanced needs focused on internal acceptance. However, other researchers, such as Lawler (1966) and Yeager (1996), described money as a social measuring stick that individuals use to identify their own success and worth, thus providing utility, regardless of the actual financial needs of the individual.

Retention Bonuses

A consistent trend in compensation for high-profile executive positions within high-turnover industries, such as the financial industry, is the use of retention bonuses (Burchman & Jones, 2008).

These bonuses help reduce the incentive for executives to move from less profitable companies to more profitable companies and ride out market turbulence. Many executives have come to rely on bonus awards, and are motivated to switch firms with less strict award criteria. This phenomenon has further expanded the importance of retention bonuses, providing security to executives and focusing the executives on long-term performance (Burchman & Jones, 2008).

Executive Compensation Agency Theory

The following section of the literature review provides background on historical executive compensation issues and theory. Agency theory is described, including the effect it may have on executive performance. In addition to agency theory, several competing executive compensation theories are described, including marginal productivity theory, human capital theory, stockholder theory, and stakeholder theory.

Historical Overview

Executive compensation has evolved significantly over the past 100 years, moving from simple cash compensation to complex equity ownership. Prior to World War II, executive compensation was closely aligned relative to the average worker's compensation. Executive management was compensated based on production output and its perceived value to the organization (Taussig & Barker, 1925). As organizations became larger and management teams became more diverse, new forms of compensation began appearing. Compensation research identified the need for different compensation practices for executives in differing stages of their careers. Young executives often have significant fixed expenses, such as cars, homes, and other debt, making them less likely to seek significant compensation based on company performance. More seasoned executives find company performance-based compensation appealing due to the high reward and increased challenge (Foote, 1971; Gordon, 1940).

In 1971, the primary compensation for executives was still direct salary, though other forms of compensation, including equity or partnership shares, were also in use (Foote, 1971). By the 1980s and

1990s, equity-based compensation was in full-usage. Equity-based compensation allowed executives to earn higher compensation packages while reducing the amount of expense incurred during the short-term. Equity awards were viewed as a significant method to reduce cash salary expenditures while tying executive compensation to share-price performance throughout the equity-vesting period. Often equity awards were given in the form of stock options, a pre-determined stock purchase quantity an executive could purchase at a discounted price. The discounted price is only useful to the executive if the share price is lower than market price when the stock options mature.

Stock options were highly valued by executives and shareholders prior to the regulations initiated in the early 21st century, because current accounting practices minimized the effect stock options had on net profit (Aboody & Kasznik, 2008). Despite the obvious agency theory benefits of executive ownership, critics of stock options noted that heavy usage of stock options influenced executives to make short-term decisions. Executive decision-making may have been focused on the achievement of short-term share price over long-term capital growth. Capital investment and long-term growth strategies were not as well rewarded as short-term company performance boosts. Company-wide lay-offs and competitor acquisitions had significant effects on company share prices before the actual effects of such significant decisions could be fairly evaluated.

In the early 21st century, there were several key leadership fraud cases, including the Enron, WorldCom, and Tyco scandals. These scandals highlighted the significant compensation, benefits, and power of corporate executives. The U.S. government and applicable accounting bodies, such as the Financial Accounting Standards Board (FASB), enacted several laws, regulations, and statements of accounting practices governing executive compensation reporting and accounting (Anderson et al., 2004). The purpose of these actions was to increase the visibility to investors of the effects of executive management's true compensation and expenses on the business's bottom line. Chief among the new regulations was the 2002 Sarbanes-Oxley Act, requiring publicly traded companies to disclose their top five earning executives and their salaries (Lawler, 2009). Disclosure alone did not provide enough information to the public investor, as the compensation disclosures were either too vague to provide a

solid understanding or too complicated for the average investor to decipher. The complexity of many executives' compensation packages led to additional regulations requiring the packages to be described further in plain language (Lawler, 2009).

During the 2008 financial crisis, several key U.S. financial institutions lost value because of risky lending and accounting practices. Many researchers believe these risky practices were taken in part because of compensation practices rewarding short-term, risk-taking behaviors over long-term strategies. Steven Kaplan, professor of entrepreneurship and finance at the University of Chicago Graduate School of Business, testified to Congress regarding executive compensation in America (Bogle, 2008), and he described CEO compensation as inconsistent with company productivity. Kaplan likened CEO compensation to that of superstars of stage and athletic backgrounds, with the exception that the public chooses to compensate actors and athletes because of their easily identifiable marketable skills. Bogle provided evidence disputing many of Kaplan's claims. Bogle described corporate profits growing at the rate of overall economic growth, refuting the argument that CEO salaries should grow because of increases in profitability. Additionally, Bogle noted that corporate profit growth outpaces economic growth in specific periods, preceded and followed by periods in which corporate growth lags economic growth. CEO compensation appears to grow significantly faster in periods of corporate growth lag. In regards to the comparison of CEO compensation to superstars, Bogle pointed to the leadership and long-term responsibilities associated with corporate leadership.

Research Gaps in Agency Theory

Agency theory describes the process by which organization owners tie corporate management's compensation to the goals and desires of organizational owners (Tichy & Devanna, 1990). The theory states that managers will seek to manage organizations in the best interest of themselves (Tichy & Devanna, 1990). Tying manager metrics to company performance provides incentive for managers to enhance owners' investments. One challenge in modern business is the diversity of owners' goals. Corporate shareholders include long-term and short-term investors, and these investors can provide

conflicting messages in both executive compensation and performance expectations (Aboody & Kasznik, 2008).

Aboody and Kasznik's (2008) study was to see if executive teams compensated with dividend-protected, restricted stock options encouraged executives to disperse higher dividends, whereas executives compensated with stock options that were not dividend-protected reduced dividends and used the additional cash to increase share value. Shareholders may have a preference for dividends taxed as normal income or capital gains taxed at varying rates depending on their individual situations. The results of the study were consistent with the researchers' theoretical framework. Adjusting the executive team's compensation to favor dividends or capital gains does, in fact, appear to adjust management's focus on returning value to shareholders.

Laux and Laux (2009) described the role the audit committee and compensation committees have on executive compensation. They posited that compensating an executive with equity- or performance-based compensation encourages the executive to manage earnings rather than focus on earnings growth. Executives managing earnings may sacrifice long-term corporate management for short-term success and share price manipulation. Based on this assumption of earnings management, the board of directors engages the audit committee to manage the CEO, keeping her or him focused on long-term objectives. Research shows that corporate boards separating executive compensation determination from audit committee oversight functions are more likely to use performance-based compensation packages requiring more audit committee engagement (Laux & Laux, 2009). The result is that increased performance-based compensation packages and the associated earnings management are generally countered by the increased activity of the audit committee and the company's internal audit team.

Historically, monitoring activities (management or board oversight) was considered interchangeable with the compensation (or bonding) of individuals (Hoskisson, Castleton, & Withers, 2009; Laux & Laux, 2009). In essence, organizations could choose one practice or another to ensure agents of the organization worked for the good of the shareholder. Hoskisson et al.'s (2009) research indicated that these two functions are complementary rather than substitutes. Thus, increases in

monitoring responsibilities for managers leads to increased compensation of those managers based on the added level of responsibility and loyalty to shareholder values needed.

Marginal Productivity Theory

Marginal productivity theory describes organizations as employing and paying individuals to the extent that they add revenue to the organization (McConnell & Brue, 2005). The theory postulates that organizations with profit seeking motives will provide compensation packages of less than the value the individual's service provides the organization. In the case of an executive, the value of fixed and variable compensation should not exceed his or her measureable value to the organization (Sung & Swan, 2009). The challenge with marginal productivity theory in practice is that organizations often do not have visibility to the direct financial benefits executive-level employees have in the organization. Variable-based compensation packages, such as stock options, may provide compensation greater or less than the value the executive added to the organization because of outside influences (Sung & Swan, 2009). Other theorists postulate that as there is a relatively limited supply of effective executive-level employees, the marginal productivity is extremely high (relative to other positions within the organization), permitting increased compensation ceilings (McConnell & Brue, 2005).

Stakeholder Theory

Stakeholder theory has been gaining ground in the literature and has recently become prominent in the discussion of corporation management and compensation practices (Reynolds, Schultz, & Hekman, 2006). Cludts (2000) defined stakeholders as any individual or group of individuals who interacted with, affected, or could be affected by an organization's decisions and activities. This definition would include governmental bodies, consumers, and organizations up and down the supply chain, as well as employees, management, and stockholders. Stakeholders need not benefit or be affected financially by the organization's decisions or actions. In fact, Cludts described the different stakeholder levels of power and influence as reasons that organizations, particularly corporations, are inefficient. Various stakeholder

groups, such as employees, have a disproportionately low measure of control versus stockholders and executive managers, reducing the organization's ability to achieve goals and objectives.

Donaldson and Preston (1995) argued that all stakeholder interests are of equal priority. Each stakeholder loses utility should the organization cease to exist. Although the stakeholder model does provide interesting agency theory interpretations, the application of such theory is difficult because of the diversity of stakeholders. Even Donaldson and Preston (1995) described the theory as morally and ethically difficult to manage.

Stockholder Theory

The financial term "stock" can be described as one unit of capital for a given corporation (Boatright, 2009). Public corporations sell stock in their companies to generate additional funds to expand operations and to generate additional returns for their investors. Although some researchers directly equate stock with ownership, Boatright argued that shareholders have significantly less ability to control or direct an organization than the executive management of such organizations and are restricted as to the activities on which they can provide direct input. Others, such as Friedman (2002), described shareholders as possessing significantly more control of the direction of an organization. A corporation's only purpose, as described by Friedman, is providing financial return on investment to the shareholders. Conceptually, stockholders provide the resources and expectations for a corporation, whereas management and employees use the resources provided by investors to deliver a product or service in demand by consumers. Consumer demand translates into financial gain for the corporation and return on stockholder investment (Donaldson & Preston, 1995).

Within stockholder theory, there remains the issue of principal agent when it comes to management of an organization. Managers may have objectives that conflict with those of the stockholder. Publicly owned corporations often have diverse stockholders unable to devote their time to the management of the corporation, increasing the opportunity for principal agent issues (Brigham &

Houston, 2004). Managers may perform in activities, such as mergers and acquisitions or other one-time activities, without regard to total stockholder returns (Dorata & Petra, 2008).

Human Capital Theory

Reed, Srinivasan, and Doty (2009) described human capital theory as the theory that many organizational capabilities are components of organizational participant strengths and weaknesses, in addition to financial and physical assets. Employees and leaders provide quantifiable benefits to the organization and, in turn, must be managed for the organization to receive maximum returns. Organizations invest in human capital through effective hiring decisions, compensation strategies, and retention programs, as well as employee training and skill development (Nancherla, 2008; Subramaniam & Youndt, 2005). The organizational return takes the form of increased productivity and better employee decision-making, particularly in industries such as banking, where employees make decisions with significant financial effects (Reed et al., 2009).

Managerial Discretion Theory

Managerial discretion theorists describe managerial discretion as the ability top company executives have to adjust organizational strategy and direction without explicit direction from stockholders (Hambrick & Abrahamson, 1995; Hambrick & Finkelstein, 1995). Hambrick and Abrahamson (1995) suggested that the greater the amount of managerial discretion, the greater the executive's ability to affect organizational performance. Further, the amount of executive managerial discretion may be affected not only by stockholders, but also by the nature of the particular industry. Executives in regulated industries, industries with high cost of capital, and industries with monopolistic supply chains or consumers tend to have less managerial discretion (Hambrick & Abrahamson, 1995).

Current Findings and Prior Studies

Evaluating and Establishing Executive Compensation Performance Requirements

Storero and Stephenson (2009) discussed the board of directors' management of executive compensation in light of recent governance failings, citing situations at GE and Disney in which the compensation committee and shareholders were not completely aware of the total costs associated with compensation elements. Their research described key questions the board should ask themselves, such as the specific actions the plan wishes to reward, what compensation elements are most cost effective for the company, what is most desired by the executive, how the compensation scheme compares with the industry average, and how the company manages each element within the compensation plan. GE's ex-CEOs' expenses totaled over $2.5 million after just the first year, and Disney paid out millions in severance for a CEO who was with the company for just a few months. Storero and Stephenson (2009) suggested that companies slow down the compensation plan development process, and take a measured approach to determining what exactly they want to compensate their executives for doing.

Similarly, Matsumura and Shin (2009) noted that many compensation critics believe top management's compensation is not tied enough to the firm's performance or the benefit to shareholders. These proponents argue that the executive team's lack of ethical management practices arises because of inadequacies of agency theory Matsumura and Shin (2009) observed that the standard solution of providing more compensation in the form of executive stock ownership might only further increase the ethical issues displayed by executives. Executive shareowners have as many positive incentives to perform in earnings management techniques as executives receiving similar performance-based cash awards do. Further, share ownership has several accounting concerns that may allow organizations to shield the true cost of executive compensation from shareholders. In contrast, Lilling (2006) observed a significant and stronger than expected correlation between market performance and executive compensation, where compensation is based on an incentive scheme. Veliyath's (1999) compensation elasticity research found that compensation and performance have an elasticity rate of .1, indicating that

increased compensation does have the potential to increase overall productivity. Similarly, Vieto et al. (2008) found that more profitable organizations tended to compensate their executives at a higher level.

Despite the observed correlation between performance and executive compensation, researchers find that firm size has the highest correlation with and is the determinant of executive compensation size (Cadman et al., 2009; Nourayi & Mintz, 2008; Veliyath, 1999). Harford and Li's (2007) study evaluated the relationship between CEO compensation and shareholder gains from acquired companies. The study reported that the majority of CEOs for acquired companies benefitted financially at or above the relative gain of shareholders and in many cases were better compensated for takeovers than for expending resources on capital investment.

Vieto et al. (2008) evaluated executive compensation plans across S&P-traded corporations over a 13-year period to determine any commonality or differentiation. The research team found that organizations on the S&P 500 Large Cap, S&P Mid Cap, and S&P Small Cap lists each used different executive compensation approaches, varying the amount of stock reward. The team found that organizations in industries and on lists with significant fluctuations in share price tended to award more stock options, whereas more stable firms and lists used higher cash awards. More profitable firms were found to pay their executives higher compensation packages (Vieto et al., 2008). Dorata and Petra's (2008) study on the effects of companies whose CEOs also held positions as Chairmen of the Board and had the propensity to engage in mergers and acquisition activity found that there was an increased propensity for merger and acquisition activity in firms in which the CEO was also on the board of directors. The CEOs appeared to be motivated by the compensation increases associated with increasing the companies' relative sizes. Significant equity compensation packages with delayed share awards also led to increased CEO tenure, as the value of future share awards provided incentives for CEOs to stay (Nastasecu, 2009).

One compensation scheme compensation committees may choose to use when determining executive compensation is based on a tournament system, in which there is significant pay differentiation in the top positions (Lee et al., 2008). The objective is to provide lower level employees with increased

motivation to rise to the top. Proponents argue that performers are rewarded more and are thus more apt to perform better and differentiate themselves. The competing model, equity fairness, is based on the observation that employees working in high compensation dispersion environments portray more dysfunctional behaviors and are less likely to form cohesive teams (Lee et al., 2008).

Compensation Committee Benchmarking of Executive Compensation

Sheikh (2007) found that companies most often use internal performance standards unless the compensation committee is skeptical of the accuracy of the prior performance's prediction of future performance, or if there are significant external challenges affecting the firm. Although many companies still use internal standards, there is a movement by shareholders to use more external standards. Many larger organizations' compensation committees seeking to set more effective compensation practices look to external benchmarking to determine appropriate compensation levels (Cadman et al., 2009; Davila & Penalva, 2006).

Firms use industry and firm-specific benchmarks when setting new executive compensation levels or proposing changes to existing executive compensation packages (Cadman et al., 2009). These benchmarks often include larger firms or firms with significantly better market position and performance, thus skewing executive compensation levels. Differences identified within benchmarked peer groups and reference firms may relate to firms' biases regarding their relative performance and position within the industry. Current competitive state and desired state may be blurred.

Nastasecu's (2009) research study regarding CEO compensation and turnover indicated that compensation committees compensating at or below industry average compensation levels increase the incentive for CEOs to leave the firm. Compensation committees may choose to compensate executives on a relative performance basis similar to a benchmarking approach (Schubert & Barenbaum, 2008). Absolute models base equity-based compensation on performance indicators of the firm, such as share price. The motivation is based on the performance of the company in alignment with the shareholders' goals of higher share price or earnings per share. Relative models base executive equity-based

compensation on the performance of those same key performance indicators, but in relation to his or her ranking with competitors. Relative models provide incentive for executives, eliminating concern for industry-specific circumstances. Poor or positive economic times become less of an issue compared with the performance of the executive team. Schubert and Barenbaum (2008) indicated that either model might be preferable depending on the industry.

Earnings persistency is one factor when benchmarking executive compensation practices across industries (Ashley & Yang, 2004). Earnings persistency is the degree to which the company's earnings are consistently high over time. Companies in growth industries or industries prone to the effects of recession, such as the technology industries and hospitality industries, respectively, may have corporate earnings declines completely out of the control of executive leadership teams. Companies with low earnings persistency may offer aggressive bonuses to reward executives for good years at a rate greater than that of companies with high earnings persistency (Ashley & Yang, 2004).

Compensation's Effect on Corporate Decision-Making

Scholars generally agree that company compensation practices are conceptually designed to influence business decisions (Burchman & Jones, 2008; Canarella & Gasparyan, 2008; Chen, 2004; Crumley, 2006; Gordon, 1940; Matsumura & Shin, 2005). Company owners and shareholders are increasingly being encouraged to align executives' compensation to their own interests. As executive compensation becomes increasingly determined by company performance metrics, there is an increased risk that executives will take part in earnings management. Discretionary benefits can be and are used by executives to help manage company performance to investor expectations. Discretionary spending benefits, as well as short-term performance bonuses awarded to executives, represent significant risks to the long-term performance of organizations (Kwon & Yin, 2006). Executives in growth industries, such as technology organizations, have incentives for managing corporate financial sales and profitability in consistent, predictable increases. To achieve this consistency, executives may increase short-term expenses, including benefits and non-essential capital purchases, to maintain the illusion of consistency.

The literature promotes the audit committee as the chief investigator of executive earnings management practices; however, there is reason to doubt the effectiveness of this control, based on the difficulty in identifying misuse of discretionary benefits and the potential conflict of interests for members of the board of directors who benefit from the illusion of consistent performance (Laux & Laux, 2009). Examples include smaller corporations preparing for potential third party buy-outs.

Jarque's (2008) study explained that the overall executive compensation trend has been to increase regulation and management of CEO compensation, often creating increasingly complicated procedures and burdens on organizations. Matolcsy and Wright's (2008) study evaluated the performance differences of firms compensating executives with cash versus equity-based compensation. Additionally, the study attempted to determine the most efficient compensation structure for firms based on the individual attributes of the firms. The study concluded that firm performance does not significantly vary between cash-based compensation structures and equity-based compensation structures. The study, however, found that there were performance decreases when firms used less than optimal compensation structures, such as low-performance-based compensation, or the use of non-relative performance measures.

Shareholders may prefer dividends taxed as normal income or capital gains taxed at varying rates depending on their individual situations. Aboody and Kasznik's (2008) research study evaluated the effect individuals' compensation taxation policy has on how executives manage firm profits. The theoretical framework of the study was that executive teams compensated with dividend-protected, restricted stock options may encourage executives to disperse higher dividends, while executives compensated with stock options that are not dividend protected may reduce dividends and use the additional cash to increase share value. Adjusting the executive team's compensation to favor dividends or capital gains did, in fact, appear to adjust management's focus on returning value to shareholders.

Industry Implications

Compensation size and form differ from industry to industry. Differences in environmental factors and regulatory differences influence compensation committees to adjust the form and substance of executive compensation. Kwon and Yin's (2006) research study examined compensation differences between high- and low-technology firms. The team found that high-technology firms tended to have larger compensation levels because of their increased use and size of stock options and grants compared with traditional cash compensation. High-technology firms were also found to provide higher bonuses and discretionary benefits to their executives.

Cultural Effects on Executive Compensation Practices

Internationally, there are significant differences between compensation practices and their effects on compensation. Kubo (2005) stated that the cultural differences regarding independence and risk-taking between Japanese and Western managers contribute to differences in compensation practices. In contrast with Western counterparts, Japanese executives are more risk averse than the traditional U.S. or United Kingdom (UK) executives. The results of Kubo's (2005) research show that Japanese corporations with higher pay for performance compensation strategies display significantly more risk aversion. The increased risk of lower compensation forces executives to take more conservative approaches, potentially damaging the long-term profitability of their organizations.

Contrasting with Japanese companies, compensation for Canadian executives is similar to American organizations. A study of 184 publicly traded Canadian companies found that compensation committee reports regarding executive compensation were not sufficiently detailed to provide evidence of exact criteria for certain executive bonus awards. Cash bonuses for several of the firms were as much as eight times the executives' base pay. Only 10 of the 184 companies reviewed did not have significant cash bonus awards in their executive compensation packages (Schiehll, 2005).

Global organizations have additional challenges when establishing compensation strategies cross culturally. Gunkel, Lusk, and Wolff's (2009) research study evaluated the differences in employee incentive plan effectiveness across four countries through a case study of a German multi-national company with operations in China, Germany, Japan, and the U.S. The team found that what motivates employees in one country may actually provide a disincentive in another market. The team found that U.S. employees prefer the opportunity for high earnings and advancement over each of the other groups studied. The study revealed that the Japanese group found stock options non-motivating because of the high taxes and relative newness of this form of compensation. Additionally, the Chinese employees preferred more immediate benefits over long-term compensation.

Regulatory Environment

The U.S. has created several laws governing executive compensation components and reporting in the latter part of the 20th and early part of the 21st century. Lawler (2009) reviewed several of these American laws applicable to CEO compensation. The laws reviewed include the 1993 changes to taxation policy on executive compensation packages of more than $1 million, as well as the 2006 legislation requiring that CEO compensation packages be disclosed in plain English. Lawler (2009) noted that these policies did little to reduce overall compensation, and contended that any legal changes would only change the form and mix of executive compensation rather than the overall size. Instead, Lawler recommended that U.S. corporations separate the responsibilities of CEOs leading to inflated compensation, such as chairing the board of directors. Reducing the CEO's influence on the board will enable directors to take a stronger stance on compensation control and allow the development of stronger performance metrics.

In 2009, the U.S. established the Fair Pay Act, increasing the amount of time a person can file a discrimination claim regarding pay (Grant et al., 2009). The Fair Pay Act increases the potential liability an organization may face because of differences in executive compensation for women and minorities. American multinational organizations are held accountable to the local laws in the markets they operate

in, as well as American laws and regulations. All American-controlled corporations are held accountable to the Title VII anti-discrimination regulation. As such, American businesses are prohibited from discrimination practices in their leadership promotion and development practices throughout their global operations. Although discrimination lawsuits dealing with local employees may be rare or non-existent, concerns identified in the international setting could have a profound effect on settlements and damage awards for litigation within the U.S. and Europe (Hardman & Heidelberg, 1996). Grant et al. (2009) evaluated the compensation practices and packages of women CEOs and top executives as disclosed in the public financial statements of American publicly traded corporations. The results indicated there were significant differences in the total compensation of women versus men in a direct comparison, in part because of tenure and level of position differences.

Financial Crisis

In 2008, the U.S. suffered a financial crisis when several large financial institutions announced that they had severe financial problems caused by their exposure to toxic assets, such as subprime mortgages, and that other assets needed to be devalued because of the collapse of the early 2000s housing bubble. The size and scope of the financial crisis was such that both the Bush and Obama presidential administrations helped pass legislation providing funds to keep several large financial institutions from bankruptcy (Nothwehr, 2008). These funds are collectively known as TARP, or simply as the banking bailout. In exchange for TARP funds, financial institutions issued equity stakes in their organizations to the government, effectively giving the government ownership in their companies. Companies could then repay the TARP funds at a later date, in effect buying out government ownership (Nothwehr, 2008).

In addition to the equity ownership given to the U.S. government, TARP-funded financial institutions are overseen by the Financial Stability Oversight Board, the Congressional Oversight Panel, and a presidential appointee, the special inspector general for TARP. These oversight boards are responsible for overseeing the responsible usage of TARP assets and ensuring that the funds are used by corporations to further the economic interests of the U.S. (Nothwehr, 2008). This oversight has become

important to the study of compensation, as organizations receiving TARP assets proposed and awarded significant compensation packages to employees in the form of bonus payments. These bonuses ranged from hundreds of thousands to millions depending upon the employee's level and contribution. The oversight organizations quickly rebuked the financial organizations and forced the TARP recipients either to scale back or to defend their employee bonus awards. Many of the TARP-funded organizations defended their bonus awards as a customary and necessary practice to retain talent and reward employee performance. In some cases, bank employees received significant bonuses, although the banks themselves reported significant financial losses (McGregor, 2009; Taleb, 2009; Wright 2009).

Federal Reserve Proposed Compensation Changes

In the wake of the 2008 financial crisis, the Federal Reserve presented a plan to limit how finance industry employees, specifically bankers, are compensated. The plan proposes that the Federal Reserve will have the power to reject compensation plans approved by company boards of directors if they believe the compensation structure incentivizes unnecessary risk. The purpose of the proposed plan is to provide increased government control over bank governance and to reduce risk-seeking behavior in finance employees, from loan officers to CEOs (Paletta & Hilsenrath, 2009).

Presidential Proposed Government Regulation

Due to the U.S. financial crisis in 2008, President Barack Obama called for sweeping reform of the American banking and financial system (Olson, 2010). Chief among these reforms is the proposal limiting the size of banks and other financial institutions to prevent companies attaining the status of too big to fail. The President's proposal includes legislation giving the Federal Reserve the ability to monitor further for potential systematic failures and to take action when appropriate. In addition to increasing oversight of general financial operations, the President set out potential regulation, allowing current regulators of financial institutions the ability to set compensation guidelines, particularly over bonus awards. Regulators would be charged with evaluating the effectiveness and appropriateness of current

compensation practices in the financial industry, particularly when executives are rewarded for what the administration considers excessive risk-taking (Ashton & Rushe, 2009). Executive bonuses awarded to financial industry executives are oftentimes significantly higher than the average U.S. citizen's wages. Proponents of increased regulation cite the significant bonuses paid out to executives despite corporate failures as a sign that bonus plans are not really increasing firm performance (McGregor, 2009).

Critics of the President's proposed changes to compensation regulations expressed concern that the changes recommended may reduce incentives for business owners and executives to increase firm performance (Olson, 2010). The purpose of bonus plans is to tie agents further to the goals of the stockholders; the elimination of bonus plans may inadvertently push management base salaries upwards and reduce the incentive for executives to increase firm profitability or growth. McGregor (2009) argued that bonus plans provide the motivation for employees to take calculated risks for their stakeholders.

Limitations of Studies

The majority of current research provides data including multiple industries. This form of data is subject to macroeconomic shifts in industries and government activity. The evaluation of specific industries eliminates many of these extraneous variables (Jarque, 2008; Jonas, 2007). Additionally, compensation studies at the executive level are primarily focused on tying compensation levels to the performance of the firm rather than individual performance. Measuring individual performance at the executive level is difficult because of the inability to quantify the effects of alternative decisions (Lilling, 2006).

Traditionally, regression analysis has been the primary method for researchers to establish a correlation between company performance and executive compensation (Matolcsy & Wright, 2008; Murphy, 1999; Sheldon, 1997; Vieto, et al., 2008). Cordeiro, Mukherjee, and Kent (2006) suggested that standard regression analysis does not take into consideration industry-specific factors affecting executive compensation. Using a technique known as data envelopment analysis, they analyzed CEO compensation for 213 firms, taking into consideration industry specific concerns and variations. Interestingly, the

researchers discovered that firms with more outside directors are more efficient with their CEO compensation; however, no relationship was identified between efficiency and board size, CEO tenure, number of external CEO board members, or institutional shareholders. Further research on the relationship between different board of director backgrounds, tenure, and company relationship status may provide the field of compensation studies with additional insight into how companies can optimize their compensation planning processes.

Financial Industry

Industry Characteristics

The finance industry includes banking, investment, insurance, and other financial services organizations. Financial organizations may provide business-to-business services, as well as consumer products. In general, the finance industry is considered a service industry regulated by state, federal, and international regulations. Within the U.S., finance employees are generally not unionized and are primarily compensated by annual salary, commission, or a combination of the two (BLS, 2009).

The financial industry has grown and become more complex, along with the industrialization and modernization of the U.S. economy (Peretz & Schroedel, 2009). Whereas early banking focused on loans to farms and industrialization, modern financial services have developed new income streams, including various forms of consumer and corporate credit, as well as the development of shorter-term investments. Regulation of the finance industry has also grown and developed. The introduction of the Federal Reserve System in 1913 allowed regulators to monitor and adjust the monetary supply as well as banking interest rates. Further regulations throughout the latter half of the 20th century focused on reducing the inherent risk of financial activities and lessening the impact of the business cycle. After each financial crisis, there appears new and more robust regulatory apparatus designed to reduce business cycle effects ("Cycle Clips", 2008; Peretz & Schroedel, 2009).

Compensation Levels

The finance industry most resembles the compensation structure of high-technology firms with their application of equity compensation awards. According to the BLS (2009), the finance industry comprises banking, financial planning, investment, and insurance. Employees are generally well educated, contributing to an increased median income compared with many other industries. The 2008 median wage, including bonuses, for business and financial operation was $64,720 (BLS, 2009).

In January 2010, the *Wall Street Journal* reported that major U.S. banks and securities were set to pay approximately $145 billion in wages, bonuses, and other benefits for 2009 (Grocer, 2010). The projected compensation in 2009 represents an increase of 18% more than 2008 compensation levels and a 6% increase over 2007's record-setting compensation levels (Grocer, 2010). To provide context, in 2007 a mid-level manager or director in the financial industry could earn up to $2 million a year (Rosenbush, 2007).

The increases may accelerate governmental regulation of finance industry compensation. Financial consulting companies, such as Deloitte, predict increased regulation of compensation, and that current compensation packages of finance industry executives based on stock options and company profits will be reduced or negatively impacted based on current perception and market conditions (Deloitte, 2009).

Scott Alvarez, General Counsel to the Board of Governors of the Federal Reserve System, described compensation levels and strategies used by financial firms as a contributing factor to the U.S. 2008 financial crisis. The key issue cited by Alvarez was the focus on reward for financial risk-taking. Financial organizations' compensation schemes were designed to promote innovation and risk-taking over more conservative financial management approaches, thus creating a higher level of industry risk (Scott, n.d.).

Conclusion

Based on the review of applicable literature, there are opportunities to review how compensation relates to overall performance in the financial industry. The ultimate goal of compensation for management is the safety and effective management of shareholder assets. Agency theory, or the theory that compensation, whether by increasing ownership through including equity awards or increasing cash bonuses for achievement of objectives, provides incentive for increased executive performance, is the principal theoretical framework for this study (Matsumura & Shin, 2005). Management compensation theory has evolved from the generalized study of agency theory and pay for performance to the detailed study of long-term versus short-term compensation balance (Storero & Stephenson, 2009). Compensation and compensation structure represent a tool that many organizations' boards of directors use to enhance the effectiveness of their management teams (Dorata & Petra, 2008; Hartford & Li, 2007; Storero & Stephenson, 2009).

Although the actual effects may be disputed, there is significant research indicating that adjustment to compensation structure may have an effect on management decision-making. The consistent growth in executive earnings compared with average employee earnings has brought an emphasis to the compensation concerns of leaders within the academic, shareholder, and governmental communities. Further, the significant government actions taken in the industry after the 2008 financial crisis have brought management compensation for executives in particular into the spotlight (Mason-Draffen, 2008). Governmental agencies, including the current president, have highlighted potential programs and strategies regulating executive compensation. These strategies proceed from the assumptions that executive compensation provides diminishing returns and that standard financial industry practices, such as retention and performance bonuses, reward risk-taking behaviors, reducing the overall security and performance of financial institutions. Additionally, there is a significant opportunity to gain an increased understanding of how executive compensation affects overall executive engagement, motivation, and retention.

Summary

Chapter 2 provided a summary of recent and historical literature related to executive compensation. The increase in equity compensation, along with growing corporate profits, has driven executive compensation to record levels (Bogle, 2008). Additionally, the fight for top talent pushes organizations to benchmark their compensation practices with competitors, driving compensation even higher (Cadman et al., 2009). Executive compensation theory has evolved from the generalized study of agency theory and pay for performance to the detailed study of long-term versus short-term compensation balance. Previous research has shown that compensation may have a significant effect on company and personal engagement, retention, and performance. Several extraneous variables may call into question the correlations achieved in prior studies.

Despite the apparent relationship between compensation and company performance, there is room for new studies to define better whether the relationship holds true at the industry level (Cordeiro et al., 2006). Additionally, there is a significant opportunity to gain an increased understanding of how executive compensation affects overall executive engagement and retention. Based on the literature review discussed in Chapter 2, Chapter 3 will provide a description of how these compensation theories were tested and reviewed in this study.

CHAPTER 3: METHOD

The purpose of this quantitative, ex post facto correlation research study was to describe the relationship between annual executive compensation and end-of-year fiscal year financial share price by analyzing publicly available data submitted to the SEC in Fortune 500 financial industry companies. The relationship between executive compensation and company stock price over a five-year period from 2003 through 2007 was investigated using Spearman's Rho correlation coefficient. Corporate performance and executive compensation rates for each company (as listed in each company's proxy statement), were measured through changes in each financial company's SEC filed 10K reports, financial statements, and proxy statements.

In Chapter 2, a thorough review of applicable literature using seminal and recent research studies was presented. The purpose of the literature review was to provide an understanding of historical and current executive compensation research, providing a framework for the research study within the literature. Chapter 3 contains details of the research method and design appropriateness, research questions, population, sampling frame, data collection, instrumentation, validity and reliability, and data analysis.

Research Method and Design Appropriateness

Research Method

This research study investigated whether there was a relationship between annual executive compensation and end-of-year fiscal year financial share price by analyzing publicly available data submitted to the SEC in Fortune 500 finance industry companies. The independent variable in the study was executive compensation as measured by a combination of wages, bonuses, health and welfare benefits, stock options/awards, and additional benefits, such as corporate travel. The top five executives'

compensation listed on each company's 10K was averaged and used as that company's score on the independent variable. The dependent variable was the end-of-year annual stock price for each organization, in each year from 2003 through 2007.

Nature of the Study

This study uses a quantitative, ex post facto correlation research method to describe the relationship between annual executive compensation and end-of-fiscal-year financial share price by analyzing publicly available executive wage data submitted to the SEC in Fortune 500 finance industry companies. Crumley's (2006) study of the relationship between organizational performance and CEO compensation in the U.S. commercial banking industry, Veliyath and Bishop's (1995) study of firm performance, and Morlino's (2008) study of the relationship between CEO compensation and organizational performance in the U.S. airline industry provided much of the conceptual framework for this study. Prior studies (Jonas, 2007) identified the variables in this research study: executive compensation and company share price.

A quantitative approach was proposed to determine the correlation between total executive compensation and corporate share price. With the ease of access to accurate and specific data points, a quantitative correlation approach allows the researcher to extrapolate the results of the data across the industry with a reasonable assurance of accuracy. Performance metrics were obtained from company historical share price performance as listed on the NYSE and from corporate SEC financial statement findings, established as legitimate corporate performance sources in studies, such as Jonas (2007) and Lilling (2006).

Other research methods considered for this study include qualitative designs, such as case study or Delphi methods. A qualitative research design was deemed inappropriate because the results cannot be extrapolated across a population (Creswell, 2002; Neuman, 2004). A qualitative research design identifies and describes variables but cannot definitively describe relationships between variables within a

system (Creswell, 2002; Neuman, 2004). Prior studies have identified the variables related to the research question, and ample data are available to identify potential data correlation (Jonas, 1007, Morlino, 2008). A qualitative Delphi analysis would provide data for future change and was not considered because of the abundance of current data and the unknown potential significant changes in the regulatory environment.

Research Questions

The purpose of this quantitative, ex post facto correlation research study is to help leadership determine the existence or non-existence of a correlation between executive compensation and annual average share price in Fortune 500 financial companies. The research question is then:

RQ1: What is the correlation between executive compensation and share price in Fortune 500 financial companies?

Hypotheses

Research hypotheses include a statement clearly explaining the expected or anticipated outcomes of the research questions (Creswell, 2002; Neuman, 2004). The hypotheses selected for this research study were designed to determine the potential for executive compensation to relate or correlate to finance industry corporate share prices. The independent variable, executive compensation, includes cash and non-cash rewards, in line with prior studies (Jonas, 2007; Morlino, 2008) and was measured against the dependent variable, corporate share price. Corporate share price was used as an identifier of measurable corporate performance. A correlation between executive compensation and share price in Fortune 500 financial companies would indicate a likelihood of increased or decreased share performance in organizations with differing levels of executive compensation (Jonas, 2007). The following null and research hypotheses were developed from research question RQ1:

H1O: There is no correlation between executive compensation as measured by cash, cash equivalents, and non-cash compensatory awards and publicly traded New York Stock Exchange-listed corporate share price movement from 2003 through 2007 in Fortune 500 financial companies.

H1A: There is a correlation between executive compensation as measured by cash, cash equivalents, and non-cash compensatory awards and publicly traded New York Stock Exchange-listed corporate share price movement from 2003 through 2007 in Fortune 500 financial companies.

Population

The population for this research study includes all Fortune 500 financial industry companies and their associated top five highly compensated executives. Financial industry companies include companies in the banking, investment, insurance, and other financial services organizations (BLS, 2009). The top five executives always include the CEO and CFO, as well as the three most highly compensated executives in other positions within the company (Jonas, 2007).

Sampling Frame

This research study reviewed a sample of Fortune 500 finance industry companies' share performance and the average compensation for their top five compensated executives as reported by the company to the SEC. Based on the public availability of share price data from Dow Jones MarketWatch and corporate executive compensation figures from corporate 10K and proxy statements filed with the Federal Government as posted and obtained from the EDGAR-online database, an organization population of 37 corporations was established. Of the original 37 financial companies identified, seven were liquidated, discontinued, or had data unavailable within the five-year period and were thus removed from the sample. The removal was acceptable based on the goals of the study and the non-discriminatory nature of the removal. A sample of 30 publicly traded Fortune 500 financial industry companies was selected with a 99% confidence level using an Excel random sample selector script. A 99% confidence level is desirable for increased accuracy when extrapolating to the population (Frankfort-Nachmias & Nachmias, 1992). Sampling provides the researcher with a view of the characteristics of an entire population and only requires the researcher to review a smaller number of representative data points (Frankfort-Nachmias & Nachmias, 1992).

It was necessary to sample publicly traded organizations because private organizations do not have traded shares or publicly available compensation data. There are significant differences between publicly traded and private organizations. Private organizations do not generally equate equity share value with organizational performance. Management of private organizations has different priorities compared with management of publicly traded organizations (Jonas, 2007).

The researcher decided to average the compensation of the top five executives from each organization based on the public availability of the top five executive compensation data for publicly traded companies within the U.S. Furthermore, the top five compensated executives represent an appropriate sample based on their status as the top earners for the organization (Jonas, 2007). By using an average of the top five earners, instead of just the CEO/CFO, the metric is more representative of the companies' compensation policy for top leaders, overall.

Performance metrics were obtained from company average annual historical share price performance as listed on the NYSE or other relevant stock market exchanges. Share price was deemed an appropriate metric for performance because of the tie-in with executive yearly bonus structure metrics. Five annual data points were used (2003–2007). The five-year period was based on the availability of the data, as executive compensation data was not publicly available for publicly traded companies prior to 2002.

Informed Consent

Certain factors related to this quantitative, ex post facto correlation research study precluded the need for informed consent requirements. Due to the ex post facto public availability of all stock price and executive compensation data required for this study, no participant contact is necessary (Frankfort-Nachmias & Nachmias, 1992).

Confidentiality

Certain factors related to research study preclude the need for informed consent confidentiality requirements. Due to the ex post facto public availability of all stock price and executive compensation data required for this study, no confidentiality agreement will be necessary (Frankfort-Nachmias & Nachmias, 1992). Research and analytical materials will be retained for a minimum of five years in electronic copy when possible.

Geographic Location

The sample for this research study is not geographically dependent. The population is made up of various Fortune 500 corporations with operating and reporting locations throughout the U.S. and the rest of world. This study will only include organizations publicly traded on U.S. stock exchanges filing 10K reports with the U.S. SEC. Whereas it is certainly possible that location may affect compensation practices, the size of the sample and sample limitation of Fortune 500 organizations reduces the likelihood of geography influencing the correlation analysis.

Data Collection

This research study used secondary data sources for both share price data and executive compensation data for the sampled Fortune 500 companies. Share price data for each of the sampled companies was obtained from average share price historical data for each of the sampled five years obtained from the MarketWatch online database. Executive compensation data for each of the sampled companies and sampled years were obtained through EDGAR-online's historical SEC 10K filings.

This study uses secondary data sets as the primary source of research data. The use of secondary data presents several benefits and risks. Review of the literature shows several potential concerns with the use of secondary data. Secondary data analysis runs the risk of the researcher using data that are not appropriate for the research questions or type of research study (Kiecolt & Nathan, 1985). The research data or materials may not be appropriate for the particular research design needed to achieve reasonable

conclusions related to the research questions (Robson, 1993). For this research study, the benefits of secondary data outweigh the aforementioned concerns. Secondary data allows the researcher to identify trends and to pursue research questions differing from the original data collector. The researcher can also validate prior studies and substantiate earlier presented trends (Frankfort-Nachmias & Nachmias, 1992). Additionally, secondary data analysis allows the researcher to increase prospective sample sizes to accommodate more representative samples and to perform more exhaustive research. Publicly available secondary data also allows the researcher to obtain more complete representation without bad or unusable samples. The samples and source data are then available to future researchers wishing to recreate or evaluate the research study (Frankfort-Nachmias & Nachmias, 1992).

Data from both MarketWatch and EDGAR are publicly available within the U.S. financial system. Alternatives to MartketWatch include Yahoo Financials, HQuotes, and QuoteMedia. None of the alternative sources carries the same professional weight and ease of use as MarketWatch. MarketWatch is a member of the DowJones & Company family of business. Each sampled company's average share price for the five sampled years will be recorded in table format. Additionally, market high and market low rates for the organizations will be recorded for each company and each sampled period.

EDGAR-online is the online database used by the U.S. SEC to store current and historical publicly traded company 10K and proxy statement filings. SEC filed 10K and proxy statements are regulatory documents prepared by corporations and are amended if any inaccuracies are identified. The 10K and proxy statements contain data on the top five executive compensation packages within the organization. For each sampled year, the executive positions, as well as corresponding compensation package totals and any supplementary information provided, will be recorded in table format. The purpose of selecting executive compensation packages disclosed on the proxy statements is to ensure that the study captures the highest-compensated employees, including the CEO and CFO positions. Additionally, for each sampled organization, data such as total revenues, total expenses, gross profit, and net profit will be recorded in table format. Additional information collected may provide insight into additional factors or variables for future studies.

This quantitative, ex post facto correlation research study uses secondary data sources for both share price data and executive compensation data for the sampled Fortune 500 companies. Due to the ex post facto public availability of all stock price and executive compensation data required for this study, no instrumentation is necessary. Secondary data sources were deemed acceptable because of the comparable nature of the data and the goal of determining high-level correlation rather than causation.

Validity and Reliability

Internal Validity

This study used secondary data sources for both share price data and executive compensation data for the sampled Fortune 500 companies. The secondary sources used in this study are considered valid because of the ex post facto public availability of all stock price and executive compensation data required for this study through the MarketWatch historical stock price databases and SEC'S EDGAR database.

External Validity

This study used secondary data sources for both share price data and executive compensation data for the sampled Fortune 500 companies. The secondary sources used in this study are considered valid because of the ex post facto public availability of all stock price and executive compensation data required for this study through the MarketWatch historical stock price databases and SEC's EDGAR database. The EDGAR database contains the same information submitted to the U.S. Federal Government by corporations. MarketWatch is a publicly available global premier stock price reporting service.

Reliability

This research study will use secondary data sources for both share price data and executive compensation data for the sampled Fortune 500 companies. The secondary sources used in this study are

considered reliable because of the ex post facto public availability of all stock price and executive compensation data required for this study through the MarketWatch historical stock price databases and SEC's EDGAR database.

Data Analysis

Data in this quantitative, ex post facto correlation research study were analyzed using bivariate descriptive and inferential statistics. Descriptive statistics were used to describe the variability in executive compensation and average stock prices for the participating companies. Spearman's Rho was used to determine whether there was a significant relationship between executive compensation and corporate performance for Fortune 500 companies.

The study follows non-parametric analytical methods. Non-parametric techniques allow researchers to identify patterns in data and draw conclusions when there is limited evidence on the distribution of variables in a population group (Cordeiro et al., 2006). Specifically, this study will use Spearman's Rho non-parametric statistical approach, designed to assess the relationship between two variables using a monotonic function. The preferred statistical approach for studies such as this is the Pearson Product Moment Correlation Coefficient (Jonas, 2007; Myers & Wellbrick, 2010). Social researchers use the Pearson Product Moment Correlation Coefficient as a tool to identify the magnitude of relationships between two variables. The Pearson Product Moment Correlation Coefficient cannot be used in this study due to the likelihood of significant non-normality in the compensation and share price datasets (Myers & Wellbrick, 2010). The small sample size also reduces the likelihood that the distribution of data points will be normal.

Data in this study will be analyzed using IBM's Statistical Package for Social Sciences (SPSS) version 17 (graduate package). Specifically, SPSS will be used to perform a Spearman's Rho analysis of the data. SPSS is a commercially available software analytical tool used to run various statistical analyses on sample and population data sets. The tool has functionality for descriptive statistics, bivariate analysis, predictions of numerical outcomes, and predictions for identifying groups (Statsoft, 2010).

Data Presentation

Data in this research study were presented as accepted, rejected, or failed to accept in regards to the hypotheses. Results are presented in Chapter 4 in the form of charts, figures, and tables. Discussion and analysis of the results will be presented in Chapter 5.

Summary

Chapter 3 described how differences in executive compensation were compared against overall company performance as measured by company stock price over a five-year period from 2003 through 2007. This quantitative, ex post facto correlation research study uses secondary data sources for both share price data and executive compensation data for the sampled Fortune 500 companies. Data were analyzed using bivariate descriptive and inferential statistics. Specifically, Spearman's Rho was used to determine if there is a significant relationship between executive compensation and corporate performance for Fortune 500 companies. Chapter 4 will report the results of the study including all applicable tables, charts, and figures.

CHAPTER 4: RESULTS

The purpose of Chapter 4 is to report the results of this quantitative, ex post facto correlation research study. The purpose of this quantitative, ex post facto correlation research study was to describe the relationship between annual executive compensation and end-of-year fiscal year financial share price by analyzing publicly available data submitted to the SEC in Fortune 500 financial industry companies. The research data address the research question of how annual executive compensation correlates to end-of-year fiscal year financial share price in years 2003-2007.

Chapter 4 reports the results of the study including applicable tables, charts, and figures. The study's findings are presented with the research question, hypothesis, and then the results of the statistical analysis. Chapter 5 will include a review of the data and interpretation.

Research Question

The purpose of this quantitative, correlation ex post facto research study was to determine if there was a relationship between executive compensation levels and corporate share price. The key independent variable in the study was executive compensation as measured by a combination of wages, bonuses, health and welfare benefits, stock options/awards, and additional benefits such as corporate travel, over a five-year period from 2003 through 2007. An average of the top five executives' compensation, listed on the each company's 10K report, was used as the independent variable. The dependent variable was the overall stock performance of the organization over a five-year period from 2003 through 2007. The relationship between executive compensation and stock prices was evaluated using Spearman's Rho correlation coefficient. Based on the aforementioned research strategy, the following research question was developed:

RQ1: What is the correlation between executive compensation and share price in Fortune 500 financial companies?

Hypothesis

The following null and research hypotheses were developed from the research question:

H1O: There is no correlation between executive compensation as measured by cash, cash equivalents, and non-cash compensatory awards and publicly traded New York Stock Exchange-listed corporate share price movement from 2003 through 2007 in Fortune 500 financial companies.

H1A: There is a correlation between executive compensation as measured by cash, cash equivalents, and non-cash compensatory awards and publicly traded New York Stock Exchange-listed corporate share price movement from 2003 through 2007 in Fortune 500 financial companies.

Variables

Executive compensation is the only independent variable used in the study. Company stock price at the end of the company's fiscal year represents the dependent variable used in the study. For the purposes of this study, executive compensation is defined as the sum of all reported compensation elements including salaries, bonuses, and other compensations for the top five highly compensated executives as indicated in the sampled companies' 10K SEC filing.

Data Collection

The study includes tests of the dependent and independent variables to identify outliers and to ensure they are representative of the sample. The sampled Fortune 500 financial organization population included 37 corporations. Of the original 37 financial corporation population, seven were liquidated, discontinued, or had data unavailable within the five-year period and were thus removed from the sample. The removal was acceptable based on the goals of the study and the non-discriminatory nature of the removal. The following data analysis relates to the 30 selected samples. In some analyses performed, BLK was removed due to missing data in 2007.

Share price data for each of the sampled companies were obtained using historical data as listed on MarketWatch's BigCharts publicly available online financial data service for each of the sampled

companies' fiscal year-end during the sample period. Executive compensation data for each of the sampled companies and sampled years were obtained through the Securities and Exchange Commission's EDGAR-online's historical SEC 10k filings. The top five earners listed on the 10K were determined based on total compensation. Individuals who were retiring from the organization were still included. In all cases the chief financial officer and chief executive officer were included in the sample. Other positions commonly included were the chief operating officer and treasurer.

Data Analysis Procedure

Inferential statistics were used to draw conclusions from the sample population tested. The Statistical Package for the Social Sciences (SPSS) was used to code and tabulate scores collected from the survey and provide summarized values where applicable including the median, mean, central tendency, variance, and standard deviation. Descriptive and inferential statistics including a Spearman's Rho analysis were used to determine if there was a significant relationship between executive compensation and stock prices for Fortune 500 companies.

Analysis of Research Question 1

RQ1: What is the correlation between executive compensation and share price in Fortune 500 financial companies?

Descriptive and inferential statistics were used to evaluate Hypothesis 1 for Research Question 1. Since the data set was relatively small (n = 29), the average compensation and stock amounts across 2003-2007 are provided in Table 1 and Table 2 to give an idea of the distribution of scores. Note that the original sample of 30 was reduced by one as BLK did not have all necessary data available for the 2007 year. Table 1 is ranked by average stock price over 2003-2007 and Table 2 is ranked by average executive compensation over 2003-2007. Graphs of the change in compensation and stock prices over time (2003-2007) for companies with the highest average stock prices are provided in Figures 1 through 5. In order to put both stock price and executive compensation on the same scale, the raw scores for each

were transformed to z-scores. The formula for computing z-scores is z = (x□ - x)/s where *x*□ is the mean score for the company across the five years, *x* is the company's score for that year, and *s* is the standard deviation for the company across the five years.

Table 1

Average Stock Price and Executive Compensation by Company Over 2003-2008 Fiscal Years Ranked by Stock Price

Company	Avg. Compensation	Avg. Stock	Rank Comp	Rank Stock
AIG	43306185.40	1106.35	7	1
CME	8507566.40	372.86	28	2
GS	165520000.00	152.80	2	3
EFTC	24251929.80	148.92	11	4
BEN	14107318.80	83.44	18	5
LM	22009079.20	78.40	14	6
DNB	13778590.20	69.75	19	7
DST	15205582.80	59.79	16	8
LEHMQ	71952856.80	55.46	4	9
AXP	42245678.80	51.22	8	10
MS	87454350.20	50.38	3	11
ADS	13093797.60	49.64	20	12
MCO	12860761.20	47.98	21	13
FISV	8979069.00	46.18	27	14
SLM	22336480.00	43.01	13	15
TROW	19945619.80	39.10	15	16
GE	48824950.40	35.36	5	17
MMC	36587437.40	33.94	9	18
EFX	11829591.80	33.52	23	19
AOC	23032262.20	33.36	1	20

AJG	9488649.80	29.92	26	21
NADQ	11450261.60	28.02	25	22
LUK	15179982.40	27.51	17	23
CFC	47343780.20	22.70	6	24
JEF	32490760.00	21.80	10	25
RJF	11634377.80	20.37	24	26
SCHW	22542124.60	16.67	12	27
AMTD	12139989.40	16.60	22	28
INTL	2009613.80	13.69	29	29

Note. n = 29, BLK not included in mean

Table 2

Average Stock Price and Executive Compensation by Company Over 2003-2008 Fiscal Years Ranked by Executive Compensation

Company	Avg. Compensation	Avg. Stock	Rank Comp	Rank Stock
GS	165520000.00	152.80	1	3
MS	87454350.20	50.38	2	11
LEHMQ	71952856.80	55.46	3	9
GE	48824950.40	35.36	4	17
CFC	47343780.20	22.70	5	24
AIG	43306185.40	1106.35	6	1
AXP	42245678.80	51.22	7	10
MMC	36587437.40	33.94	8	18
JEF	32490760.00	21.80	9	25
EFTC	24251929.80	148.92	10	4
AOC	23032262.20	33.36	11	20
SCHW	22542124.60	16.67	12	27
SLM	22336480.00	43.01	13	15

LM	22009079.20	78.40	14	6
TROW	19945619.80	39.10	15	16
DST	15205582.80	59.79	16	8
LUK	15179982.40	27.51	17	23
BEN	14107318.80	83.44	18	5
DNB	13778590.20	69.75	19	7
ADS	13093797.60	49.64	20	12
MCO	12860761.20	47.98	21	13
AMTD	12139989.40	16.60	22	28
EFX	11829591.80	33.52	23	19
RJF	11634377.80	20.37	24	26
NADQ	11450261.60	28.02	25	22
AJG	9488649.80	29.92	26	21
FISV	8979069.00	46.18	27	14
CME	8507566.40	372.86	28	2
INTL	2009613.80	13.69	29	29

Note. n = 29, BLK not included in mean

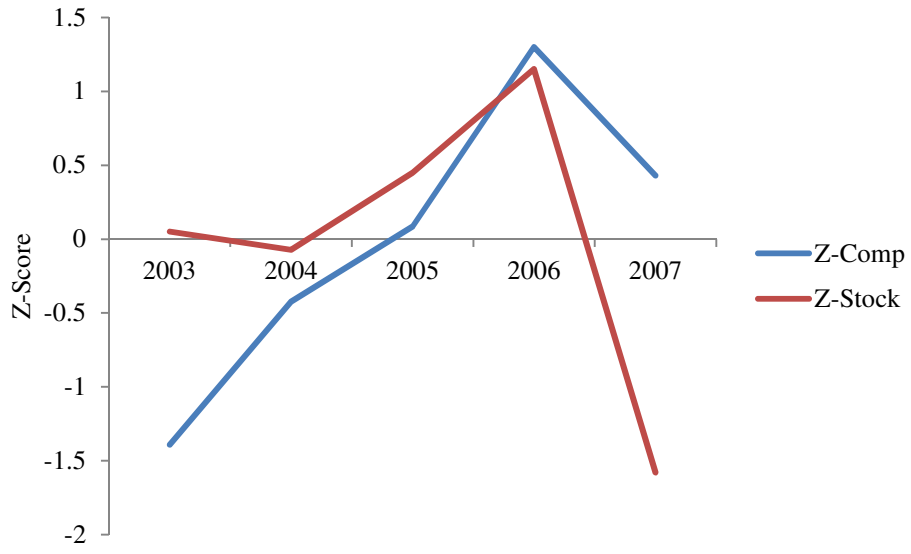

Figure 1. Graph of the change in executive compensation and stock price across 2003-2007 for AIG

The scales in the Figures 1 through 5 are in standard deviation units, meaning that the change in stock price and compensation is in reference to the average values for that company during 2003-2007. Figure 1 represents the change in executive compensation and stock prices for AIG throughout the sample period. Visually, one can see there is a slight correlation between these two variables with compensation and stock price at AIG rising and falling consistently, though at slightly different rates.

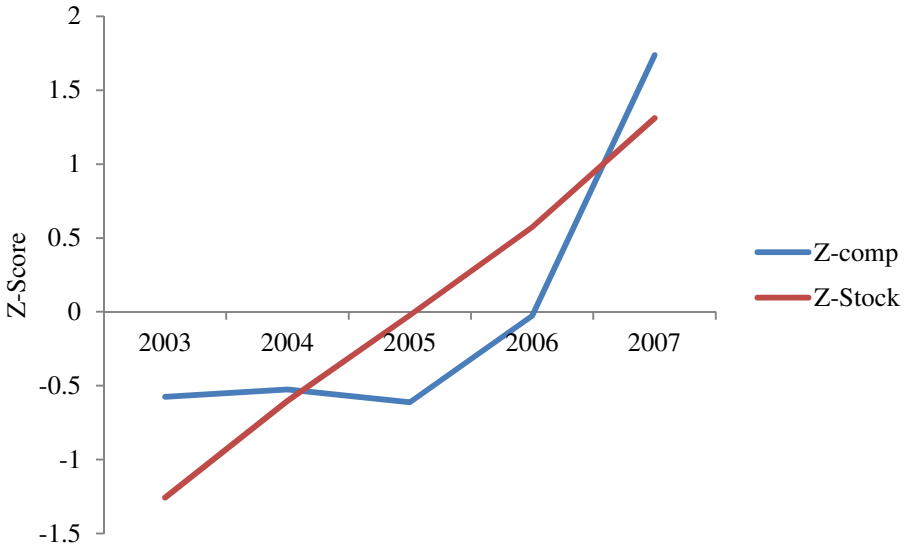

Figure 2. Graph of the change in executive compensation and stock price across 2003-2007 for CME

Similar to the results of Figure 1, Figures 2, 3, and 5 show positive visual correlations of varying degrees. The observed visual correlation for CME provides an example where extraneous variables such as executive turnover or compensation deferral have potentially affected compensation levels in 2004 and 2005.

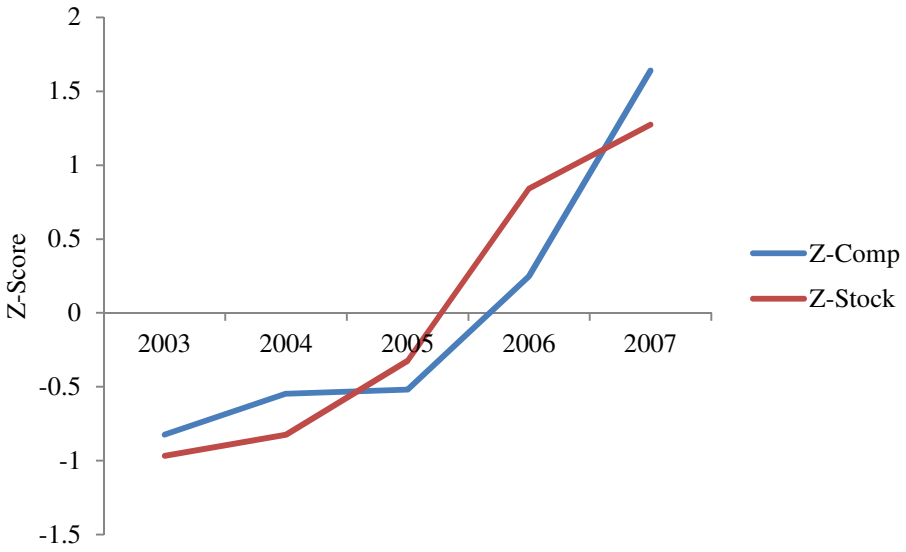

Figure 3. Graph of the change in executive compensation and stock price across 2003-2007 for GS

As noted previously, Figures 1 through 5 represent the visual representation of the relationship between compensation and stock movement. While Figures 1,2,3, and 5 display visually similar compensation and stock movement, visual review of Figure 4 notes that movement between compensation and stock in year's 2003, 2004, and 2005 significantly varied. This variation is repeated throughout a majority of the sample as viewed in the data included in Tables 1, 2, and 3. During data collection, the researcher noted many of the organizations underwent management changes through years 2003-2005 that may have affected the overall correlation analysis. Additionally, stock performance in the latter years of the sample appeared to be affected by the sharp economic downturn described in Chapter 2. The speed at which the downturn affected organizational performance may have caused a lag between stock price movement and compensation adjustment.

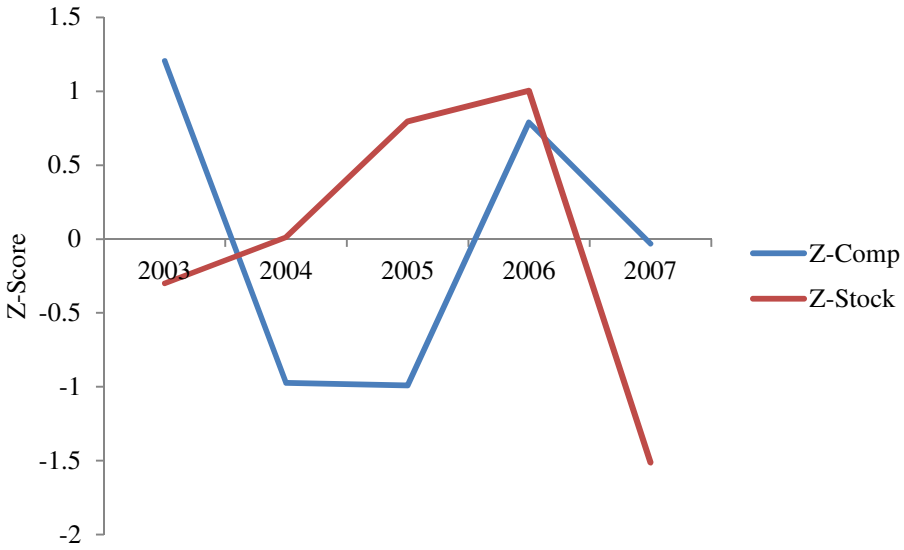

Figure 4. Graph of the change in executive compensation and stock price across 2003-2007 for EFTC

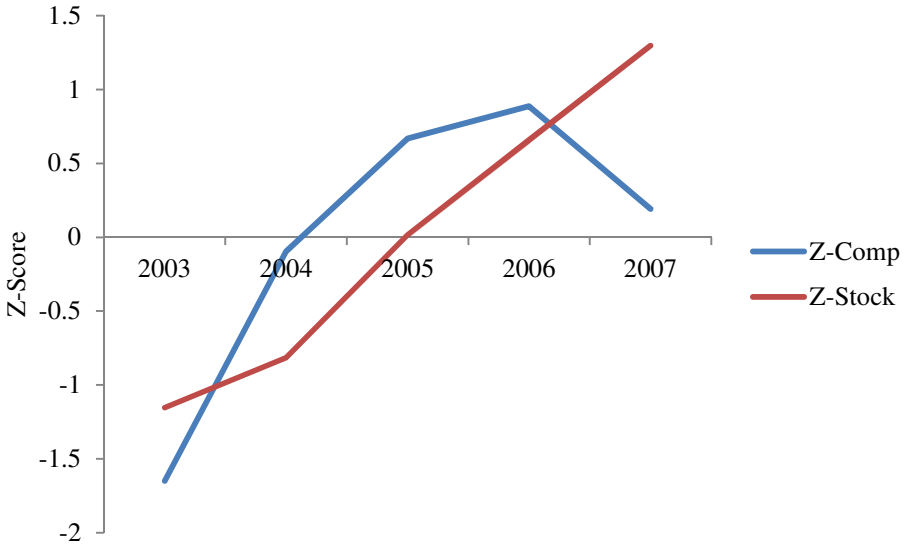

Figure 5. Graph of the change in executive compensation and stock price across 2003-2007 for BEN

The descriptive statistics above provide a picture of the sporadic relationship between executive compensation and stock prices for the firms with the top five average stock prices across 2003-2007. Inferential statistics were used to evaluate the relationship between executive compensation and stock

price for the entire sample. Specifically, Spearman's Rho correlations were computed for each time point and are provided in Table 3 below.

Table 3

Summary of Spearman Rho Correlations for Compensation and Stock from 2003 to 2007

Variable	1	2	3	4	5	6	7	8	9	10
2003 Avg. Comp	1.000	.929**	.849**	.878**	.812**	.363*	0.238	0.191	0.173	-0.051
2004 Avg. Comp	.–	1.000	.846**	.806**	.768**	0.408	0.277	0.259	0.241	0.108
2005 Avg. Comp	.–	.–	1.000	.936**	.828**	.388*	0.303	0.284	0.293	0.191
2006 Avg. Comp	.–	.–	.–	1.000	.851**	0.342	0.271	0.237	0.249	0.055
2007 Avg. Comp	.–	.–	.–	.–	1.000	0.286	0.244	0.223	0.233	0.096
2003 Avg. Stock	.–	.–	.–	.–	.–	1.000	.912**	.840**	.830**	.550**
2004 Avg. Stock	.–	.–	.–	.–	.–	.–	1.000	.930**	.932**	.665**
2005 Avg. Stock	.–	.–	.–	.–	.–	.–	.–	1.000	.976**	.742**
2006 Avg. Stock	.–	.–	.–	.–	.–	.–	.–	.–	1.000	.795**
2007 Avg. Stock	.–	.–	.–	.–	.–	.–	.–	.–	.–	1.000

Note. n = 30 for 2003-2006, n = 29 for 2007 (BLK did not have compensation data for 2007). One asterisk (*) indicates significant at $p < .05$, two asterisks (**) indicate significance at $p < .001$

The correlations between each possible pair of compensation levels (e.g., 2003 Avg. Comp and 2004 Avg. Comp) were all significant (all p's < .001). The correlations were positive and large indicating that if companies were ranked high regarding executive compensation levels in one year they were likely to be ranked high in previous and subsequent years as well. The correlations between each possible pair of stock prices (e.g., 2004 Avg. Stock and 2007 Avg. Stock) were also all significant (all p's < .001). These correlations were all large and positive, indicating that companies with high-ranking stock prices in one year were likely to be ranked high in previous and subsequent years (and vice versa for companies that were ranked low).

Where companies ranked concerning executive compensation and stock price was relatively stable across time points. Across 2004-2007, where companies ranked concerning average compensation was not significantly correlated with where companies ranked in terms of stock prices (the darker shaded cells in Table 3). However, there was a significant correlation between where companies ranked in terms of executive compensation and stock prices in 2003. The relationship was moderate in size ($r = 0.363$, $p < .05$; Cohen, 1988). As companies' ranking regarding executive compensation increased, their ranking regarding stock prices also increased.

Assuming that there may be a time lag in the relationship between compensation and stock prices, the correlations between executive compensation in one year and stock prices the subsequent year may also be of interest (the lighter shaded cells in Table 3). None of these correlations were significant. Company rankings in terms of executive compensation in one year did not predict rankings regarding stock prices the following year. Based on this information, the null hypothesis that there is no relationship between company rankings regarding executive compensation and stock prices was retained.

Summary

The purpose of Chapter 4 was to report the results of this quantitative, ex post facto correlation research study. The purpose of this quantitative, ex post facto correlation research study was to describe the relationship between annual executive compensation and end-of-year fiscal year financial share price by analyzing publicly available data submitted to the SEC in Fortune 500 financial industry companies.

The results of the descriptive and inferential statistics analysis of Hypothesis 1 revealed a non-significant relationship between executive compensation and share performance. As such, the null hypothesis was retained. Low power, due to small sample size may have affected the results of this study. Studies in this area are affected by the relatively small population and may not have enough power to detect a significant relationship between executive compensation and stock prices, even if a relationship

does exist in the population. Chapter 5 will describe the results reported in Chapter 4 and elaborate on how the findings impact the existing research on leader compensation and firm performance.

CHAPTER 5: CONCLUSION

The purpose of Chapter 5 is to analyze the results of this quantitative, ex post facto correlation research study. The purpose of this research study was to describe any relationship between annual executive compensation and yearly average financial share price through an analysis of publicly available data submitted to the SEC by Fortune 500 financial industry companies. Executive compensation in the financial industry has been disputed as disproportionate to overall company performance (Crawford, 1999; McGregor, 2009; Taleb, 2009; Wright, 2009). A misalignment in executive compensation compared with company performance may represent diminished overall corporate profitability and an opportunity for decreased shareholder value (Johnson & Natarajan, 2005).

A review of the literature showed there are opportunities to review how compensation relates to overall performance in the financial industry. Agency theory, or the theory that compensation, whether by increasing ownership through including equity awards or increasing cash bonuses for achievement of objectives, provides incentive for increased executive performance, is the principal theoretical framework in this area (Matsumura & Shin, 2005). Management compensation theory has evolved from the generalized study of agency theory and pay for performance to the detailed study of long-term versus short-term compensation balance (Storero & Stephenson, 2009). Still, compensation and compensation structure represent a tool that many boards of directors use to enhance the effectiveness of their management teams (Dorata & Petra, 2008; Hartford & Li, 2007; Storero & Stephenson, 2009).

What researchers have overlooked to this point is an examination into the relationship between employee compensation and the overall performance of companies within a specific industry such as the financial industry. The majority of current research provides data including multiple industries and is subject to macroeconomic shifts in industries and government activity. The evaluation of specific industries eliminates many of these extraneous variables (Jarque, 2008; Jonas, 2007).

Engaged employees and managers provide increased productivity to the organization, and engaged leadership has also been shown to support the level of total-company morale (Mastrangelo, 2009). Strong executive retention has the potential to affect positively the overall performance of the organization, and for this reason companies have traditionally sought to compensate executives based on how the executives affect the overall organization (Gordon, 1940). However, in such a model, there is potential for compensation to be misaligned with overall company performance (Johnson & Natarajan, 2005). Executive compensation in the financial industry has been disputed as disproportionate to overall company performance (Crawford, 1999; McGregor, 2009; Taleb, 2009; Wright, 2009), and such misalignment may diminish overall corporate profitability and create a risk for decreased shareholder value (Johnson & Natarajan, 2005). The problem is that over the past 25 years, the gap between CEO compensation and average employee wages has risen from 420% more than the average employee's wages to 3,001% more than the average employee's wages (Anderson et al., 2004).

The purpose of this study was to describe any relationship between annual executive compensation and end-of-fiscal-year financial share price through a statistical analysis of publicly available data on top-executive compensation submitted to the Securities and Exchange Commission (SEC), and Fortune 500 financial industry company stock performance. The research question that framed this study was: "What is the correlation between executive compensation and share price in Fortune 500 financial companies?" This question was answered through a quantitative ex post facto study that reviewed a sample of Fortune 500 finance industry companies' share performances and their associated top five compensated executives as reported by the company to the SEC. Chapter 4 provided a full account of the data and results of the survey. The following section provides an overview of the findings.

Summary of Findings

The guiding research question, "What is the correlation between executive compensation and share price in Fortune 500 financial companies?" was analyzed using Spearman's Rho analysis to

determine whether there was a relationships between executive compensation and share price among Fortune 500 companies. For this analysis, the share price of 30 Fortune 500 companies provided the predictor variable, and executive compensation was the criterion variable. Review of the data indicated a sporadic relationship between executive compensation and stock prices for the firms with the top five average stock prices across 2003-2007.

The Spearman's Rho correlation coefficient was found to be not significant, and thus there was not a significant relationship between executive compensation and stock price for Fortune 500 companies. Across 2004-2007, where companies ranked concerning average compensation was not significantly correlated with where companies ranked in terms of stock prices (the darker shaded cells in Table 3). However, there was a significant correlation between where companies ranked in terms of executive compensation and stock prices in 2003. The relationship was moderate in size ($r = 0.363$, $p < .05$; Cohen, 1988). As companies' ranking regarding executive compensation increased, their ranking regarding stock prices also increased. Additionally, the correlations between each possible pair of compensation levels were positive and large indicating that if companies were ranked high regarding executive compensation levels in one year they were likely to be ranked high in previous and subsequent years as well.

Restatement of Limitations

A variety of limitations naturally constrain the conclusions drawn from this research. The potential limitations discussed in Chapter 1 were affirmed during the study. The study represents a narrow focus on executive compensation and share price for publicly traded Fortune 500 finance industry corporations within the U.S. The study is limited to compensation and share price data from after 2003 because of the limited availability of reliable executive compensation data prior to the implementation of the Sarbanes-Oxley Act of 2002. While evaluation of specific industries eliminates many of the extraneous variables that affect both compensation and performance, there are many specific variables that can affect compensation or performance at the individual company level (Jarque, 2008; Jonas, 2007).

The results obtained in this study and the associated conclusions are constrained by the low power. The failure to identify a significant correlation between executive compensation and share price for Fortune 500 companies may be a result of the small sample size rather than the absence of a relationship between the two variables. As with any research, it is important to recognize the limitations associated with the research design and analysis, but they should not diminish the value of the research. With these limitations noted, the following section considers the conclusions and implications stemming from this study.

Conclusions and Implications

Understanding the degree to which executive compensation and share price interact is significant because of the potential to help practitioners adjust their operational strategy. With the increased focus on executive compensation after the 2008 financial crises ("Make them Pay", 2008), the finance industry faces the potential for government analysis and involvement in determining the compensation levels for key executives ("Better Pay for All," 2007). The failure to identify a relationship between these two variables has implications for leadership motivating and retaining key executives as compensation packages may be unduly relied upon to influence executive behaviors. Additionally, the results of this study provide background for a greater understanding of the potential benefits or detriments of increased compensation regulation. A lack of correlation between compensation and share performance could indicate that performance measurements outside of share performance are more significant to compensation committees. Conversely, a strong correlation may indicate that regulatory constraints on compensation could unduly affect share performance.

The results of the analysis contradict Veliyath's (1999) research, which showed a slight correlation between CEO compensation and company performance. The results of this study indicate a need for publicly traded organizations to evaluate their compensation practices. In contrast to Ashley and Yang's (2004) study on earnings persistency, the data from this qualitative correlation study shows that executives in organizations performing consistently are not necessarily more likely to have

correspondingly high compensation. This challenges Ashley and Yang's (2004) model, which posits that organizations should compensate for consistent long-term performance over short-term performance.

The results of this study also call into question the common assumption that executives benefit from earnings management practices where short-term performance is stunted in favor of long-term financial consistency. This idea has been advanced by Laux and Laux (2009) and Kwon and Yin (2006), who have asserted that earnings management practices are rewarded by the marketplace. Earnings management practices may not have any influence over executive compensation in relation to employee compensation overall. The next section discusses proposals for future studies that may help identify such trends.

Recommendations for Further Study

Several recommendations for future research in this area can be suggested. This study provides a correlation analysis of a very specific industry. Based on the results indicated and the concerns about the low power of the sample, the first recommendation is to repeat the study with a larger population group and subsequent sample size. Replicating the study in this way will confirm the results of this study and dispel any question about the existence or non-existence of a relationship between these two variables. Furthermore, a repeat of this study using data collected after the 2008 financial crisis may provide a contrasting look at compensation and performance. A larger sampling of years may provide leadership with a longer-term view of compensation's effects on performance.

This study maintained a narrow focus on only two variables of interest. Additional insights may be gained through a more comprehensive, detailed, analysis of compensation and share performance across the finance industry. Additional areas of analysis might include the addition of profit and acquisition variables. The incorporation of additional performance variables may help explain the lack of significant correlation in the study results. The results of these additional studies may add to the literature and further enhance understanding of compensation and performance.

Similarly, a wider view of compensation practices on share performance could be provided through a larger study incorporating several industries. Doing so may allow the researcher to extrapolate results across a broader section of the U.S. economy. Understanding how industries' compensation practices vary or remain consistent may enhance researchers and corporate leaders' ability to predict trends and identify opportunities for compensation optimization.

Additionally, future studies may focus on variables such as length of executive service and prior experience. It is reasonable to suspect that executives with more distinguished careers may require higher compensation over time. Beyond research, the application of this study also shows potential for improving practice in the field of leadership. The final section of the paper provides recommendations for improving practice based on the results of the research.

Recommendations for Practice

The results of this quantitative, ex post facto correlation research study leadership provides organizational leaders and the academic community with a better understanding of how compensation relates to overall company performance. Based on the results of the study and review of the literature, the author recommends compensation committees should follow a BAKE strategy when managing executive compensation practices. Organizations should look to incorporating BAKE quality into their executive compensation strategies and programs.

The *B* refers to "benchmarking" executive compensation against other similar organizations. Benchmarking includes integrating relative compensation metrics into the executive compensation framework. Organizations should carefully evaluate their benchmark companies.
Cadman, Carter, and Semida (2009) suggest that companies consistently choose benchmark organizations that do not match their organizations' actual size and performance.

For the *A* in *BAKE*, compensation committees should "align" executive compensation to organizational specific long-term objectives. The align stage is where absolute metrics for executives are included in the compensation setting process. Compensation components based on organizational size

and structure would be included at this point. This aligns with Ashley and Yang's (2004) theory describing the benefits of compensation targeted to long-term performance over short-term performance. Alignment of compensation to short-term objectives provides a risk that the

The *K* in *BAKE* stands for "keeping track." Compensation committees should work with the audit committee to understand what audit-related findings and themes are identified as well as how those themes relate to the compensation of executives. This responsibility is critical for the compensation committee to understand how executives are executing their duties with regard to the motivating factors of the executive compensation plan (Laux & Laux, 2009).

The *E* in *BAKE* stands for "evaluation." Compensation committees should evaluate the effectiveness of each year's compensation structure on at least an annual basis. In addition to annual analysis, quarterly analysis will provide compensation committees with an understanding of how the compensation plan is affected by current performance. Instituting more structured and comprehensive reviews of executive performance may provide for better compensation decision-making in addition to other benefits to corporate governance (Laux & Laux, 2009). Adjustments to compensation programs should be based on empirical analysis conducted as part of the quarterly executive compensation analysis.

Summary

Executive compensation has become a significant political, academic, and corporate concern in the wake of the 2008 government bailouts of large financial institutions (Mason-Draffen, 2008). Compared with average employee wages, executive compensation has risen significantly throughout the 1980s, 1990s, and early 21st century (Anderson et al., 2004). Previous research indicates there may be a connection between compensation and corporate performance (Jonas, 2007). Executive compensation in the financial industry has been disputed as disproportionate to overall company performance (Crawford, 1999; McGregor, 2009; Taleb, 2009; Wright, 2009).

This quantitative, ex post facto research study sought to describe any relationship between annual executive compensation and end-of-fiscal-year financial share price through a statistical analysis of

publicly available data on top-executive compensation submitted to the Securities and Exchange Commission (SEC), and Fortune 500 financial industry company stock performance. The principle research question, "What is the correlation between executive compensation and share price in Fortune 500 financial companies?" was reviewed through Spearman's Rho analysis of 30 sampled Fortune 500 financial companies.

The results of this study indicate that there is not a significant relationship between executive compensation and share price. However, there was a significant correlation between where companies ranked in terms of executive compensation and stock prices in 2003. Future analysis using a larger sample size and longer time period is recommended in light of these results.

The results of the analysis challenge Veliyath's (1999) research, which showed a slight correlation between CEO compensation and company performance. Laux and Laux (2009) and Kwon and Yin (2006) are similarly challenged by these results, as both studies suggested that earnings management practices are rewarded by the marketplace. The results of this study reflect no such relationship.

Based on the results of the study and the review of the literature, the author recommends compensation committees should follow a BAKE strategy when managing executive compensation practices. Organizations should look to incorporate BAKE quality into their executive compensation strategies and programs. The term *BAKE* refers to benchmarking against other companies, aligning compensation to organizational goals, keeping track of executive compensation strategies, and periodically evaluating the compensation plan to organizational performance. Formalizing and adding additional rigor to the process of executive compensation management in financial companies may provide for stronger defense against potential profit-damaging government or activist shareholder initiated compensation restrictions.

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