

SENIOR PROJECT - PROSPECTUS
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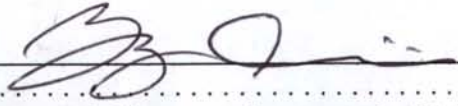
Faculty Project Advisor: Dr. Trace Woidtke

PROJECT TITLE: Executive Compensation

PROJECT DESCRIPTION (Attach not more than one additional page, if necessary):

A study of the methods and contemporary problems with executive compensation. The paper explores the trends and the possible future of executive compensation.

Projected completion date: 4/5/11/06

Signed: 

I have discussed this research proposal with this student and agree to serve in an advisory role, as faculty project advisor, and to certify the acceptability of the completed project.

Signed: Trace Woidtke, Faculty Project Advisor

Date: 5/1/06

Return this completed form to The University Honors Program, F101 Melrose Hall.

(January 2006)

The State of Executive Compensation

5/2/06

Honors Thesis

Advisor: Dr. Tracie Woidtke

By: Yazan Damiri

Disney Case Study

For many years Disney CEO and Chairman Michael Eisner has ranked near the top of the list of the most highly paid CEO's in the country. Between 1998 and 2000 Eisner made more than \$680 million from the exercise of stock options (Hodgson). Eisner made \$570 million in 1998 alone. News of his compensation ignited a public discussion on executive compensation and disclosure. Although Eisner's compensation is unquestionably exorbitant, the lingering question is did he deserve it? If Eisner had greatly increased shareholder wealth and the value of the company, a case could be made to justify his compensation. However, this is not case. Evidence shows that \$1,000 invested in Disney in 1984, when Eisner took office, would be worth \$10,901 in 2001, representing a 15% annual compound return. This sounds like a decent return; however, the average return on the S&P 500 would make a \$1,000 investment over the same period worth \$8,506, representing a 13% annual compound return. Therefore, under Eisner's leadership, Disney barely outperformed the market. In 2004, he received a 45% withhold vote for his reelection from disgruntled shareholders (Plitch). As a result, Eisner was forced to step down as chairman of the board but remained a member and CEO of the company. It seemed as if the company was finally responding to shareholders. However, despite shareholder disapproval, Eisner received compensation of \$10.1 million in 2005, his final year as CEO of Disney. Furthermore, he continues to draw on a \$297,779 annual pension from Disney (Plitch).

Eisner's case illustrates the growing concern over executive compensation and disclosure. The topic has been the subject of recent heated debate over whether executives deserve huge compensation packages, arguably, at the shareholders' expense.

As was witnessed in the Eisner case with his bid for reelection to the board, sometimes stockholders are pitted against management, creating agency problems. Also, since Eisner himself was chairman of the board it is unlikely that the board would place controls on his compensation. The case study demonstrates a text book case of entrenched management. Recent legislation passed by the SEC requires companies to disclose executive compensation in greater detail. Executive compensation has become one of the biggest issues in corporate governance. Therefore, to achieve an understanding of the issue it is essential to look at the different methods used to compensate executives, recent trends, proposed regulation, and the future of executive compensation.

Methods of Compensation

Companies use different methods to compensate executives. An ideal compensation package aligns executive incentives with shareholder interests to minimize agency problems. These methods often include a combination of: salary, bonus, stock options, stock grants, and pensions. Since the use of stock options has recently been a subject of great controversy, they will be discussed in greater detail since corporate scandals such as Enron and WorldCom have been linked to stock option grants (Hall-Murphy). However, the first component of compensation that will be discussed is one that the average employee can relate to—salary.

Salary

Salary is a fixed amount of a compensation package and does not vary in the short run (Balsam 35). However, salary can vary in the long run depending on performance. Normally, companies include clauses in compensation contracts allowing for raises that

are contingent on performance and duration. Since salary is the most risk-free component of a compensation package it is very important in attracting executive talent, especially if that individual is risk-averse (Balsam 312).

Bonus

A large portion of companies pay their executives a bonus based on performance. A bonus is a form of compensation that is conditioned upon the performance of one or more measures. According to Balsam's book, "An Introduction to Executive Compensation," these measures can be implicit or explicit, objective or subjective, or financial or non-financial. Usually, the maximum bonus is expressed as a percentage of salary; as an employee moves up in the corporate ladder, the percentage of salary that can be earned as bonus usually increases (Balsam 314). It is not uncommon for a CEO's bonus to be 100% of salary. In 2005, Wall Street bonuses set a new record of \$21.5 billion; the last record of \$19.5 billion was during the bull market of 2000 (CNN.com). Wall Street bonuses increased 15.5% over their levels in 2004 (CNN.com).

Stock Options

Stock options allow the person who receives them to purchase stock at a certain price usually over a certain period of time. Sometimes the grantee has to wait until the vesting period is over before the options can be exercised. A vesting period is a specified amount of time that the grantee must wait before exercising the options. Typically, grants are exercisable by allowing the grantee to exercise a certain percentage of the entire grant over the vesting period. An example is allowing the executive to exercise 25% of the grant in the first year of a four year vesting period and the rest at the end of the period. The use of stock options increased significantly during the 90's and has

declined amid recent controversy (Hall-Murphy). Options allowed companies to align their incentives with those of managers and provided a form of compensation that did not require an initial cash outlay. For many of the high tech startup firms of the 90's this form of compensation seemed optimal. Stock options have been the most controversial form of compensation due to several events and misuses. The majority of Michael Eisner's compensation came in the form of stock options, and some of the most prominent corporate scandals, such as Enron and WorldCom, have been linked to the excessive use of options (Hall-Murphy). One of the biggest issues surrounding the use of options is how companies should account for them.

The rules that govern the accounting for stock options are established by the Financial Accounting Standards Board (FASB) and the Accounting Principles Board (APB), which existed before FASB. The pronouncement that is concerned with the expensing of stock options is APB Opinion 25, issued in 1972, which states that the accounting charge for stock options is the difference between the market price of the stock and the exercise price on the date that the options are granted (Hall-Murphy). As a result there is no charge for options that have an exercise price that is at or above market price on the date the options are granted. However, in 1995 FASB released FAS 123 which recommended that companies expense the fair market value of options using an option pricing model, most prominently the Black-Scholes model (Hall-Murphy). The pronouncement still allowed companies to continue reporting options under APB Opinion 25, however if they chose to do so they would also be required to disclose the value of the option grant in a footnote to the financial statements. As late as 2002, only a few companies were reporting stock options using FAS 123; although, amid corporate scandal

in 2003 more than a 100 companies began to report using FAS 123 (Hall-Murphy). The reason that so many companies choose not to expense the estimated fair market value of the options is that it could significantly hurt their bottom line. Furthermore, many startup companies use a tremendous amount of stock options to attract talent to the firm because they do not have the resources to pay high salaries or bonuses.

Stock Grants

Stock grants are shares of the company's stock that are given to employees as compensation. They are valued at the market value of the company's stock and have no exercise price (Balsam 38). Stock grants are either classified as restricted or unrestricted; restricted grants cannot be sold until the employee has been with the company for a certain amount of time, whereas unrestricted shares can be sold at any time (Balsam 38). The stock grants method of compensation is not as popular as stock options because they are more expensive and they are not as effective in aligning the interests of the executives with those of the company.

Pensions

Pensions are a form of deferred compensation which the executive receives after he/she retires from the company (Balsam 39). After retirement the executive receives a payment or a number of payments. The amounts can either be in accordance with a pension plan or the executive may have an amount accumulated in a specific pension account. Accordingly, pensions are classified into defined benefit plans and defined contribution plans. Defined benefit plans distribute payments to employees based on predetermined benefit formulas, whereas in a defined contribution plan the employer's contribution is defined by the plan and the employee may add to it (Balsam 175-176).

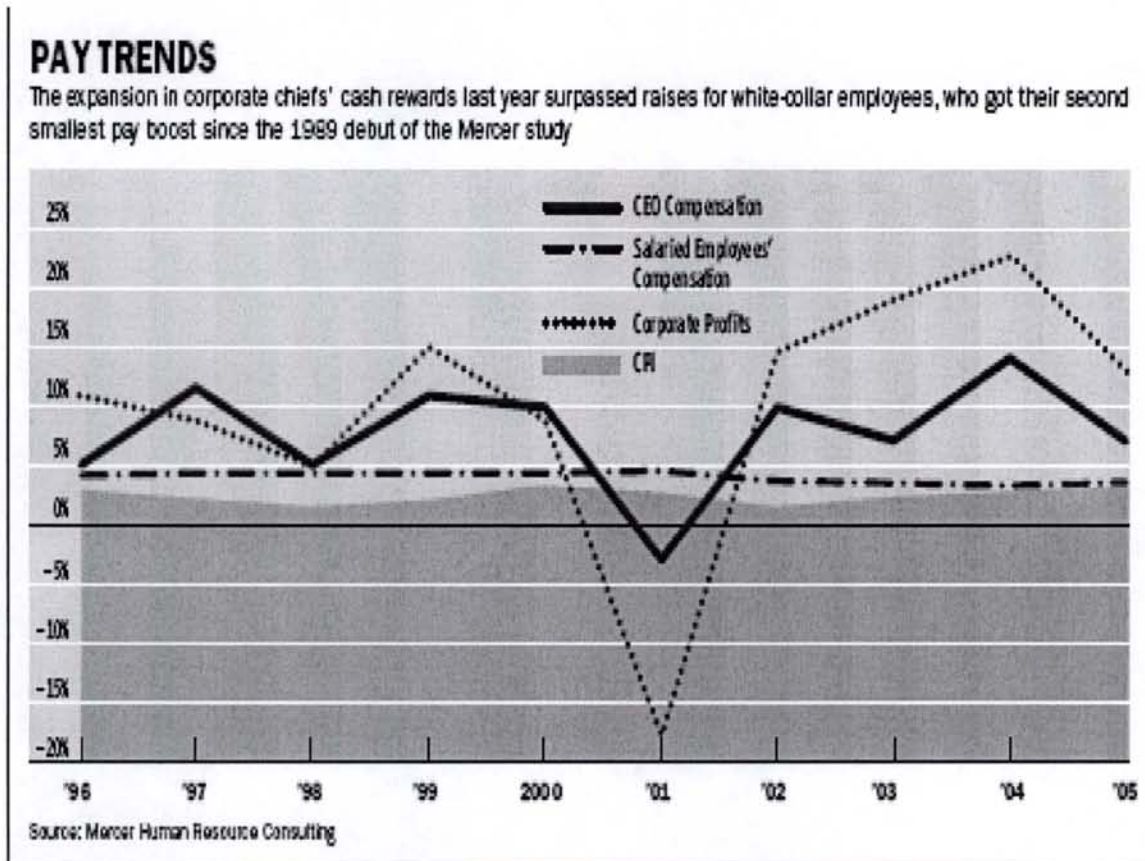
Recent cuts in employee pensions by major companies have brought pensions to the public spotlight. As mentioned earlier, Michael Eisner still draws an annual pension payment of \$297,779 from Disney (Plitch). However this seems like nothing when compared to the annual payment of \$6,518,459 to Pfizer executive Henry McKinnell (The Corporate Library). Recently, similar to Eisner, McKinnell was the target of a "Vote No" campaign by Pfizer shareholders and up to 22% of shareholders withheld their support from board members that supported McKinnell's pension (Masters). In addition to normal pensions, companies have even created special retirement programs known as "Top Hat" plans for key executives to avoid tax consequences (AFL-CIO).

Trends

In 2005 salaries and bonuses for executives rose 7.1%, after having risen 14.5% in 2004 and 7.2% in 2003 (WSJ/Mercer). The increase in salaries and bonuses for executives exceeded the 3.6% increase in pay for white-collar workers (WSJ/Mercer). However, the increase in the median total compensation for executives which includes salary, bonuses, gains from option exercise, other long-term incentive payouts, and the value of restricted shares is up 15.8% from 2004 to \$6,049,504 (WSJ/Mercer). This may seem like a drastic jump, though when compared to the 40.9% increase to \$5.9 million in 2004 it is actually very modest (WSJ/Mercer). In 2005, 192 executives exercised stock options for a median gain of \$3,493,440 in comparison to the 197 executives in 2004 for a median gain of \$3,229,072 (WSJ/Mercer). Inflation is not a valid justification, because it is obvious that the dramatic increase in executive compensation far outpaces the inflation rate. There is a growing disparity between executive and employee pay. Currently, a CEO earns 431 times the average worker's pay (Anderson). As executive

pay continues to grow this ratio continues to get larger as employee pay remains relatively stagnant. This can be observed directly from Figure 1 which plots the growth of executive compensation against the growth of employee compensation.

Figure 1



The graph shows that employee compensation has been relatively stable, whereas executive compensation has experienced significant growth. Employee compensation has not even kept pace with inflation in recent years, as can be seen by the relationship of CPI to employee salaries. It can also be observed that executive compensation varies directly with corporate profits, but is not as volatile. This can be attributed to the variable compensation components of an executive compensation package such as bonuses, stock

options, and stock grants. However, some experts question as to whether the use of variable compensation such as stock options is really in the company's interest. Recent studies have found a correlation between the use of CEO stock options and accounting and other financial restatements (Norris). Supporters of this view argue that stock options encourage executives to "cook the books." A counter argument can be made that executive compensation rises proportionately with corporate profits as is seen in the Figure 1. This raises the question of who is charged with determining executive compensation packages. Some would say it is the executives themselves who control how much they are compensated.

Another trend in executive compensation is the issue of corporate governance. The board of a company is charged with compensating the executive, however the problem is that in many instances the CEO of a company is also the chairman of the board. This issue was witnessed earlier in the Eisner case. In fact, the AFL-CIO estimates that the CEO is also the chairman of the board of directors at two-thirds of companies (AFL-CIO). This situation causes agency problems within a company and allows the executive to extract "rents," the equivalent of a monopolistic profit, from shareholders (AFL-CIO). This phenomenon raises agency costs and costs to shareholders. However, recent legislation has been proposed in the Securities and Exchange Commission to protect shareholders.

Proposed Regulation

On January 17, 2006 the members of the SEC moved to propose a plan that would make the biggest changes to the disclosure of executive compensation since 1992 (Associated Press). The plan is open to a 60 day public comment period and can take

effect as early as spring of next year (Associated Press). Under the new legislation companies would be required to provide tables in their annual filings showing the total annual compensation for the company's chairman, chief financial officer and the next three highest paid executives (Associated Press). Other provisions of the new legislation include: the reduction of the level at which executive perks must be detailed from \$50,000 to \$10,000, and disclosure of executives' retirement benefits and board members' compensation (Associated Press). Furthermore, members of the compensation committee that are not independent must be disclosed (sec.gov). Finally, companies would be required to explain the objectives behind their executives' compensation. These new regulations have been proposed to restore investor confidence in the face of booming executive compensation.

Future of Executive Compensation

Recent scandals and exorbitant abuses of corporate resources have incited public backlash against excessive executive compensation. However the question as to what is excessive must be defined first. Executives are at the helm of a company and make the major decisions which guide its ultimate success or failure. It seems justifiable that a CEO at the head of a multinational corporation deserves a significant amount of compensation for his efforts. However, there are three main issues at the heart of current executive compensation issues: performance, disclosure, and corporate governance. A CEO should be compensated according to performance by establishing certain measures to evaluate the CEO's performance. The measures should consist of short-term and long-term objectives. This is to prevent CEO's from sacrificing the long-term wellbeing of the company for short-term goals for compensatory purposes. A non-performing or mediocre

CEO should not receive compensation beyond his worth. Few would question the worth of a CEO such as Jack Welch who increased shareholder wealth significantly more than what he received in compensation. Therefore, I believe the issue at hand is whether the CEO is worth what he is being paid as opposed to the general increases in executive compensation. The idea that executives are receiving excessive compensation seems partly warranted and partly attributed to public hysteria in the wake of major corporate scandals and abuses of public trust. According to Figure 1, executive compensation has risen proportionately with corporate profits. If corporate profits were falling and executive compensation was rising, the point that executive compensation is excessive would be better validated. The other major issue, currently being dealt with by the SEC, is disclosure.

Executive compensation should be disclosed to the greatest degree so as to ensure investor confidence, especially after recent corporate scandals. Stock options should be expensed according to their fair market value. They obviously have worth when they are granted or else they would not be a part of the compensation package. The disclosure of executive perks seems justified by the fact that shareholders are essentially paying for them so they deserve to know about them. To ensure that shareholder interests are being served by the board of directors corporate governance issues must be emphasized.

CEO's should not be allowed as chairs of the board of directors because this raises agency problems and causes possible conflicts of interest. Current legislation requires that all members of the compensation committee who are not independent be disclosed (sec.gov). However, this legislation does not go far enough. Executives should not be allowed to hold the chairman position on the board of directors. There should be a

separation of power and a system of checks in balances within the corporate governance structure. Although it is not clear on how issues such as corporate governance and agency problems will be dealt with, one thing that is clear is that the public has grown disenchanted with the current system. In order to maintain public confidence, major changes must occur to encourage accountability and disclosure within the area of executive compensation.

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