CHAPTER 1
INTRODUCTION

The goals of managers and shareholders are not always aligned. Agency theory suggests this misalignment creates the need for costly monitoring through compensation contracts(Jensen and Meckling, 1976; Fama and Jensen, 1983). To align the goals of the two parties, compensation contracts should be designed to motivate the executive to make decisions that will not only increase his or her wealth, but will also increase shareholder wealth. Steps taken to increase shareholder wealth should be reflected in improved firm performance. Compensation contracts should include both short and long-term incentives. Including both components in the contracts helps ensure the decisions of the executive are linked to various time horizons. Short-term components motivate the executive to make decisions that have an immediate affect on the firm. Long-term components are necessary to lengthen the decision horizon of the executive and enhance the likelihood of continued improvement in firm value. The long-term incentives in these contracts can be based on improved shareholder wealth as well as improved firm performance.

Public outrage regarding overpaid executives has been an issue for years(Mercer et al, 1996). Shareholders have frequently implied that executives are too highly paid, relative to increases in firm value or shareholder wealth. Various types of studies have been conducted to analyze the validity of these claims.

Studies that examine shareholder response to compensation plan adoptions have provided inconsistent results. Some studies indicate positive shareholder response to adoptions (Larcker, 1983; Brickley et al, 1985), while others report no significant reaction(Gaver et al, 1992). Still other studies have evaluated the effect of various compensation schemes on firm performance or shareholder wealth using accounting measures. Some of these studies found empirical evidence of manipulative behavior by management, which is counterproductive to the goals of shareholders(Healy, 1985; Dechow and Sloan, 1991). In contrast, evidence of a link between increased compensation and improved firm performance was found by other investigators(Ely, 1992; Abowd, 1990; Crystal, 1993).

The general question regarding the link between pay and performance is as yet not fully answered. Consistencies in the methodology of a majority of prior research may contribute to the lack of a definitive answer to this question. Prior studies have typically evaluated only one accounting measure and have assumed the variable is an appropriate evaluation measure across all firms.

This study, like previous studies, examines the link between the adoption of a long-term performance based component of compensation and improved firm performance. This study relies on different methodology than prior studies to examine the link between the adoption of a long-term performance based component of compensation and improved firm performance. The differing methodology includes examining multiple accounting measures of performance and looking at these measures for specific industry groups. The variables analyzed include a general

performance measure as well as industry specific performance measures analyzed for each of nine industry groups. These variables are measured for first time adoptions of performance plans and restricted stock plans.

If agency theory holds and effective monitoring links the goals of shareholders and executives, then after the adoption of a performance or restricted plan, performance for the adopting firm, as measured by accounting variables, should improve. Results of this study indicate adoption of these plans does have a positive impact on firm performance for five of the nine industries.

It is also hypothesized that adopters of these plans will have greater improvements in firm performance than will non-adopters in the same industry. Results indicate this is not the case for all industries. In only two of the industries did adopters outperform non-adopters. In order to ascertain if the difference between adopters and non-adopters is due to compensation status or due to some other factor such as the size of either adopters or non-adopters, adopters were compared to market-size matched peers. Results from this analysis indicate that peers performed as well as or better than adopters in the same industry implying the adoption of performance or restricted stock plans does not improve firm performance above the level attained by a non-adopting peer company.

The findings in this study imply performance and restricted stock plan adoptions improve firm performance for some industries, but do not improve performance to the level attained by the non-adopting segment of the same industry.

In Chapter 2, the relevant literature on the link between executive compensation and performance is reviewed and the research questions for this study are presented. Testable hypotheses are developed in Chapter 3. The research design and methodology used to test the hypotheses, data sources, and variable definitions are presented in Chapter 4. Results of the statistical analysis are presented in Chapter 5. Finally, Chapter 6 contains a brief summary of the study and conclusions drawn from the results, as well as a discussion of the limitations of the study and implications for future research.