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Steven A. Frankforter  
*Winthrop University*

Bret Becton  
*University of Southern Mississippi*

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## CEO COMPENSATION, BACKDATED STOCK OPTIONS, AND COMPENSATION COMMITTEES

Steven A. Frankforter, Winthrop University  
Bret Becton, University of Southern Mississippi

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*CEO compensation in U.S. based companies has undergone considerable scrutiny in recent years. Among the common observations are that U.S. executives are highly paid relative to those of other countries and that the disparities in compensation are increasing over time. In this study, we investigate the effects that backdated stock options, compensation committee structure and process, and ownership factors have on levels of executive compensation. Combining agency and organizational theory perspectives, we find CEO compensation positively associated with the presence of backdated stock options, few large-block stockholders, and small compensation committees.*

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Executive compensation is an intensely debated and researched area. With arguments that CEOs are overcompensated, with problematic accountability to shareholders, calls for reform frequently appear in the popular press. With low accountability to stakeholders, CEO compensation tends to increase as the firm adopts low-risk compensation schemes (Werner, Tosi, & Gomez-Mejia, 2005). Further, weak board committee governance controls may indicate situations whereby board of director compensation committees are co-opted by CEOs, resulting in inflated compensation (Vafeas, 1999), or in innovative compensation schemes, such as backdated stock options (Lie, 2005).

According to agency theory, executives employ position power in pursuit of their economic self-interests even when it may conflict with the welfare of their corporations (Jensen & Meckling, 1976). One remedy to the agency problem is to use interest alignment mechanisms to link CEO compensation to shareholder-beneficial results. A commonly employed approach is the awarding of stock options so that CEOs benefit financially when stock prices escalate. However, in the case of backdated stock options, compensation becomes guaranteed, instead of contingent on firm performance. Backdating guarantees an often-generous profit to executives at the time of issue. A second component of agent control is board monitoring of CEOs. With director oversight, an opportunistic CEO is supposedly unable to usurp corporate assets to their own benefit. However, incentive alignment mechanisms and agent monitoring by the board may interact, resulting in compromised controls. Agent opportunism is curbed only when both are present and effectual. For example, if a firm's board uses stock options but board monitoring is weak, executives may manipulate financial information to reap unearned financial rewards. Such problems were addressed through the adoption of the Sarbanes-Oxley Act in 2002.

In this study we examine the effects of backdated stock options, ownership concentration, and compensation committee structure and processes on CEO compensation. We do not assume that all CEOs are overpaid. To the

contrary, we expect to find higher CEO compensation only with those firms that employ backdated stock options and whose compensation committee structure and processes might be relatively weak.

### HYPOTHESES

Inquiring into the determinants of CEO compensation, the hypotheses will examine one CEO compensation mechanism; backdated stock options. We also include two compensation committee factors; the number of times it meets, and its size. Lastly, we investigate two ownership factors; the number of large-block owners of shares, and CEO share ownership.

#### Backdated Stock Options

Backdating stock options permits recipients to select a date where the exercise price is low, which invariably guarantees a profit as soon as the options are granted. This practice is widespread and it has attracted the prosecutorial scrutiny of the Securities and Exchange Commission and the Justice Department. Lie (2005) reported low stock returns before corporate executive stock option grants and unusually high returns immediately after. He concluded that, unless executives had some unusual ability to forecast the future, they were most likely backdating their stock option grants. Therefore, we predict that using backdated stock options will tend to increase CEO compensation.

**Hypothesis 1.** The use of backdated stock options will be positively associated with CEO compensation.

#### The Number of Five Percent Owners

When large, concentrated block of shares are owned by a significant number of groups or individuals, it increases the likelihood of opposition to policies and actions that are not in the interests of shareholders. Highly concentrated ownership makes it easier and relatively less expensive for shareholders to coordinate among themselves and take action against firms they perceive as not serving shareholder wishes (Fama & Jensen, 1983). Such large-block owners

avoid firms with corporate governance problems. For instance, institutional ownership at companies whose management is suspected of entrenchment will tend to be lower (Frankforter, Berman, & Jones, 2000). Because of the difficulty of profitably selling large blocks of shares without making a market price drop, major investors will tend to oppose management policies not in their best interest rather than attempt to sell them.

Shareholders possessing significant equity holdings above a five percent level must identify themselves by submitting a section 13(d) filing with the Securities and Exchange Commission. These owners may have significant influence because the benefits of their involvement in monitoring a company's management outweigh the costs (Demsetz, 1983). Large-block owners have significant influence over corporate policy (Demsetz & Lehn, 1985), board composition (Pound, 1992), and help ensure that the firm's executives act to further the shareholder interests (Bethel & Liebeskind, 1993). The greater the number of five percent owners, the greater their combined ability to monitor the firm, thus, curbing agency issues, holding CEOs more accountable (Brickley, Lease, & Smith, 1988).

**Hypothesis 2.** The number of five percent owners will be negatively associated with CEO compensation.

### The Number of Compensation Committee Meetings

Among their other duties in managing executive compensation, corporate compensation committees administer shareholder-approved stock option plans. These committees determine the size and timing of stock option grants. However, it usually occurs with CEO involvement (Lie, 2005). Often, CEOs propose grant terms that compensation committees almost invariably ratify (Yermack, 1997), providing evidence of CEOs' manipulation of those interest alignment and monitoring mechanisms that might otherwise tend to curb agency problems.

Board of director rubber-stamping managerial decisions has been an oft-leveled criticism (Fleischer, Hazard, & Klipper, 1988). One solution is to increase the frequency of meetings, allowing for additional collaboration (McGrath, 1991), which can have a positive impact on team performance for groups such as boards of directors and its committees. An example of improved group performance is Vafeas (1999), who found board meeting frequency related to firm value. In light of the evidence, we predict that meeting frequency will be inversely related to CEO pay.

**Hypothesis 3.** The number of compensation committee meetings will be negatively associated with CEO compensation.

### Compensation Committee Size

Group size affects the behavior of groups, teams, and committees. In general, smaller groups complete tasks more

quickly than larger groups, and individuals tend to heighten their performance in small groups (Seijts & Latham, 2000). While this evidence supports small group size in some contexts, other empirical evidence indicates small group size may enable CEOs to manipulate compensation committees for personal gain. Several studies imply that smaller groups tend to be more cooperative with CEOs and more susceptible to tit-for-tat strategies. An examination of social dilemma research reveals that cooperation drops as group size increases (Allison, McQueen, & Schaeferl, 1992; Liebrand, Messick, & Wilke, 1992; Messick & Brewer, 1983; Seijts & Latham, 2000). Two possible explanations for this effect are: tit-for-tat strategies that promote mutual cooperation are less effective with larger groups, and the feeling of a group member's sense of responsibility to the group decreases as its size increases (Seijts & Latham, 2000). Hence, larger groups are less likely to accept the status quo, act in the self-interest of the group, and challenge decisions.

This size of boards and committees has also been the subject of much research over the years. Daily and Dalton (1993) found that greater numbers of total directors to be positively associated with firm performance. CEO domination of boards is more difficult as boards increase in size because there are more potential opponents to managerial domination (Rosenstein, 1987). Because of a higher potential for homogeneity, group cohesion, and more intense communication, smaller compensation committees are more likely to yield to CEO wishes, increasing executive compensation.

**Hypothesis 4.** Compensation committee size will be negatively associated with CEO compensation.

### Share Ownership by the CEO

When executives have little ownership in the firm, they have diminished incentives to promote shareholder wealth, and can be expected to be more self-serving (Malatesta & Walking, 1988). When CEO stock ownership is heightened, alignment with the financial interests of the firm and its shareholders increases (Eisenhardt, 1988; Jensen & Meckling, 1976). CEOs possessing substantial equity in their firms have risk and reward perceptions linked to those of the shareholders, and will be more likely to act in the shareholders' interests (Dalton et al., 2003). Higher CEO share ownership is associated with reduced instances of compensating executives with stock options (Bryan, Whang, & Lilien, 2000), diminished use of golden parachutes (Singh & Harianto, 1989), resisting takeover attempts (Stulz, 1988), and adopting poison pill takeover defenses (Malatesta & Walking, 1988).

**Hypothesis 5.** CEO share ownership will be negatively associated with CEO compensation.

## DESIGN, MEASURES, AND METHODS

### Design

We selected 166 firms identified by the Wall Street Journal as being under investigation for employing backdated stock options (Perfect Payday Options Scorecard, Wall Street Journal. (On-line). <http://online.wsj.com/public/resources/documents/info-optionscore06-full.html>). The firms so listed were subject to either Securities and Exchange Commission and/or U.S. Justice Department investigation. While the form and circumstances for investigations varied, we considered the initiation of a federal investigation a significant sign that wrongdoing may have occurred. Accordingly, we decided that named companies might be prone to agency problems and corporate governance issues. We defined the control group as firms within the same industries that were not under such investigation. We employed case-control procedures described by Seabright, Levinthal, and Fichman (1992). Case-control designs examine relatively rare events. Company size was selected as a matching variable because it could potentially confound results, because CEO compensation tends to increase with the size of the firm. Therefore, we selected the two control group firms nearest in total assets within the same 2-digit SICs to each firm in the experimental group (Singh & Harianto, 1989). The result was the initial selection of 332 control firms. The reason we selected a generous number of control firms was because we anticipated that the use of multiple data sources would result in a significant reduction of firms remaining for statistical analysis because of missing data. This design allows us to more cleanly investigate phenomena because we are not selecting or sorting firms according to the dependent variable (CEO compensation).

Missing or incomplete proxy statement data reduced the number of companies by 139. Five firms lacked Research Insight data. Finally, we eliminated 131 companies due to missing CEO compensation data. Thus, the number of firms in our study was reduced to 223; 73 were in the experimental group and 150 in the control group. We performed a t-test to determine whether asset size differed between the groups and found an insignificant t-statistic of .03. Accordingly, we concluded the firms remaining in our study were of similar size. We selected 2000 as the examination year because backdated options were invariably enacted before this date. Furthermore, the passage of the Sarbanes Oxley Act in 2002 greatly diminished the frequency of backdated stock options and also led to widespread changes in board structures and processes that would likely cloud our investigation.

### Measures and Methods

The independent variable was CEO total compensation. The dependent variables were the presence of backdated

stock options, the number of compensation committee meetings and the size of the committee, the number of large-block owners, and the proportion of the firm's shares the CEO owned.

We introduced two control variables; firm size (log of employees), and return on equity. Firm size may influence the form of power and governance structures. For example, Finkelstein and D'Aveni (1994) reported that organization size tended to affect the use of dual structures, the power of its executives, and firm performance. We controlled for firm size by computing the log of the total number of employees (Frankforter, Davis, & Vollrath, 2001) to reduce heteroscedasticity (Kerlinger, 1973).

Next, there are links between profitability and governance structure. Directors of underperforming firms exercise their authority more readily, holding management to heightened standards of accountability (Alderfer, 1986; Mizruchi, 1983). Davis, Schoorman, and Donaldson (1997) predicted that firms with high degrees of alignment between the CEO philosophy and the firm's governance structure would tend to have higher profits. We measured profitability as the firm's return on equity.

We obtained total CEO compensation from ExecuComp, defined as the sum of salary, bonus, other annual compensation, total value of restricted stock granted, total value of stock options granted, long-term incentive payouts, and all other total compensation. Firm size and return on equity data were obtained from Research Insight. All other data were collected from proxy statements. We employed multiple regression analysis to test our model.

## RESULTS

Table 1 reports descriptive statistics, variation inflation factors, and the correlation matrix. We addressed multicollinearity concerns by examining correlations and variation inflation factors. No correlation coefficient exceeded .30. Additionally, none of the variation inflation factors surpassed 1.18, far from the critical limit of 10 (Netter, Wasserman, & Kutner, 1989). These results supported our conclusion that multicollinearity did not threaten to contaminate our results.

Table 2 displays the descriptive statistics and multiple regression results. Our model reveals significant main effects for the use of backdated stock options, the number of five percent owners, and committee size on total CEO compensation. However, the result for the number of compensation committee meetings was positively associated with CEO compensation, which was in the opposite direction to that which was predicted. Therefore, hypotheses 1, 2 and 4 were supported. However, hypotheses 3 and 5 were not supported. Overall, our model had good predictive value, with a significant  $F = 3.79$  ( $p < .001$ ) and an adjusted  $R^2 = .08$ .

**Table 1: Descriptive Statistics, Variation Inflation Factors (VIFs), and the Correlation Matrix**

	Mean	S.D.	VIF	1	2	3
1. CEO compensation	10529.06	4209.66	---	---		
2. Backdated stock options	.33	.47	1.08	.10	---	
3. Number of five percent owners	2.45	1.48	1.03	-.15*	.06	---
4. Committee size	3.09	.96	1.18	-.07	-.21**	-.09
5. Committee meetings	3.46	2.54	1.14	.22***	-.17**	-.10
6. CEO ownership	.04	.07	1.11	-.02	.07	.12
7. Firm size	.64	.68	1.12	.10	-.08	-.08
8. Return on equity	8.33	85.27	1.01	.01	-.03	-.03
	4	5	6	7	8	
4. Committee size	---					
5. Committee meetings	.16*	---				
6. CEO ownership	-.17*	-.27***	---			
7. Firm size	.30***	.15*	-.06	---		
8. Return on equity	.00	.04	-.01	.08	---	

\*  $p < .05$

\*\*  $p < .01$

\*\*\*  $p < .001$

**Table 2: Multiple Regression Results**

Variables	Beta	t
Constant	---	.62
Backdated stock options	.14	2.06*
Number of five percent owners	-.15	-2.29*
Committee size	-.12	-1.78*
Committee meetings	.24	3.55***
CEO ownership	.03	.41
Firm size	.11	1.59
Return on equity	-.02	-.26
<i>F</i>		3.79***
Adjusted $R^2$		.08

\*  $p < .05$

\*\*  $p < .01$

\*\*\*  $p < .001$

With the proliferation of committees in corporate governance structures, increased attentions should be directed towards the conditions under which they function. One might ask: are the board committees effectual, or are they beneath the purview of shareholders to the point whereby CEO opportunism might be concealed? The finding that firms with higher executive compensation was linked to firms using backdated stock options, having few large-block owners, and possessing small compensation

committees provides good evidence of agency problems embedded in firms and their situations. We surmise that ineffectual structure and process at the committee level may thwart attempts to exercise control over opportunistic CEOs, resulting in enhanced CEO compensation and diminished monitoring, regardless of the firm's performance.

## CONCLUSIONS

Although agency theory and executive compensation have both been well-researched in recent years, the literature has largely ignored behavioral theory, especially concerning the composition and structure of compensation committees. This study contributes to the understanding of corporate governance by examining a variety of possible antecedents to CEO compensation, incorporating a behaviorally-oriented perspective. The results of this study provide important evidence concerning which factors or situations contribute to the overcompensation of CEOs, which will be instructive in designing remedies in the future.

While agency theory has been one of the most dominant management theories over the past few decades, little empirical evidence supports its validity, often yielding mixed and/or confusing results. For example, while Eisenhardt's (1988) argued that agency and institutional theories were both empirically valid perspectives, many other researchers argue that agency theory has little explanatory power. Dalton et al. (2003) conducted a meta-analysis of empirical ownership-performance studies, finding few examples of systemic relationships and little support for agency theory. In contrast to the objections to the value of agency theory, we found significant results with regard to understanding the conditions under which agency problems might be promulgated.

Our approach was to first assume that agency problems were either rare, or difficult to uncover. This prompted us to investigate a set of firms with a good prima facie case for agency problems – the use of backdated stock options. Additionally, we observed that researchers using agency theory often lacked a behavioral theoretical perspective, limiting their ability to effectively investigate group, motivational, and behavioral issues. We concluded that agency theory might be best tested empirically when linked to behaviorally-oriented theories.

Director cooptation does not necessarily occur at the board level. It can be achieved through the manipulation of committee structure and process. While board-level variables may appear sound, committee variables are much less observable and may be more prone to CEO manipulation. The results of this study reveal that firms having small compensation committees increase the likelihood of overcompensating CEOs. As a result, corporations ought to staff compensation committees with more members.

Although several steps were taken to lessen the effects of common method variance and measurement error, these findings and implications should be interpreted in light of the limitations of our study. We recognize that the data in this study are cross-sectional in nature. Although we employed control variables, it is possible that alternative reasons for the resulting effects exist. Future research of a more longitudinal nature should be conducted to determine if these effects change across time in the same organizations.

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**Dr. Steven A. Frankforter** is an Associate Professor of Management in the College of Business Administration at Winthrop University. He earned his PhD at the University of Washington. He has taught business policy, business & society, entrepreneurship, and accounting. His research interests are in stewardship theory, stakeholder management, mergers and acquisitions, and diversity management.

**Dr. Bret Becton** is an Assistant Professor of Management in the College of Business at Southern Mississippi University. He earned his PhD at Auburn University. His research interests include motivation and leadership.