

CHAIRMAN'S CORNER

by James A. Kaplan



The Last Decade - Part I **Score: Shareholders - Zero, Corporate Executives - Fifty-Five Billion Dollars**

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“The Big Zero,” a recent op-ed piece by Paul Krugman of the New York Times^[1], was a real eye-opener.

The author points out that this has been a decade of Zero job creation; Zero economic gain for the typical family (median household income adjusted for inflation, actually fell); and Zero stock returns, with the market closing just above the 10,000 mark at the end of 2009.

He goes on to quote a speech given in by Laurence Summers, then Deputy Treasury Secretary:

“If you ask why the American financial system succeeds, at least my reading of the history would be that there is no innovation more important than that of generally accepted accounting principles: it means that every investor gets to see information presented on a comparable basis, that there is discipline on company managements in the way they report and monitor their activities.... There is an ongoing process that really is what makes our capital market work and work as stably as it does.”

In other words, in 1999 Americans were told they had honesty in corporate accounting, which in turn allowed investors to make good decisions and allowed the financial system to function. But in fact, the opposite proved to be true.

Operating under the guise of FASB transparency and Sarbanes-Oxley compliance, many of America's largest corporations have been robbing the store as shareholders and employees suffer. Over the last decade executive officers' compensation has grown from over \$24 billion to a total of \$55 billion – an aggregate increase of 129%, or 144% computed on an individual basis (see Table I).

Table I
Average Compensation of C-Suite Executives

2000	\$1,536,377.00
2001	\$1,570,663.00
2002	\$1,797,305.00
2003	\$2,049,498.00
2004	\$2,356,254.00
2005	\$2,720,426.00
2006	\$3,745,982.00
2007	\$3,964,553.00
2008	\$3,753,240.00

The Analyst's Accounting Observer reports that by 2008, S&P 500 companies were awarding \$44.5 billion in stock grants and options to their executives while contributing only \$39.5 billion to pension plans for all other employees.^[2]

Historically, there has always been an argument justifying astronomical executive salaries (see “Why Has CEO Pay Increased so Much?” by New York University's Xavier Gabaix & Augustin Landier^[3]). After all,

aren't these the people making the important decisions that increase corporate profitability and enrich their investors?

That doesn't seem to be the case. Since 1999, earnings per share for the S&P 500 have grown from \$56.13 to \$59.65, or 6.22%, a paltry sum – particularly when compared to the 144% growth rate in C-suite salaries. I wonder how it is possible to justify more than doubling executive compensation while revenue growth, earnings, and other financial measures have deteriorated so dramatically.

By what logic are we paying them so much to run our investments into the ground? Did management deserve the \$30 billion dollar increase – or would the companies' owners (shareholders) have been better served if they had received \$30 billion in dividends? In short, this decade can be considered an age of C-suite "robber barons," and shareholders are the ones they are robbing.

In all fairness, recent years have been a struggle. Expectations were not met on many fronts, and U.S. economic domination began to wane. I could accept the argument that those C-suite managers did their best to mitigate negative results -- but I struggle with the disproportionate size of their rewards, much of it created through incentive options which were "timely exercised."

There is no evidence that increased compensation has a positive impact on corporate results. In fact, Audit Integrity's studies over the last decade-plus have shown quite the opposite, particularly in regard to excessive incentive compensation. Incentive compensation as a percent of total compensation for CEOs and CFOs is a significant measure in determining the probability of a company's poor future performance. Companies with abnormally high incentive compensation often end up as poor performers because management manipulates short-term returns to the detriment of the companies' long-term interest.

This observation is not new. In a rallying cry for a return to shareholder capitalism, in which a company's decisions are made by the owners, rather than "managerial capitalism," Martin Hutchinson quotes none other than Adam Smith on conflict of interest:

"Economic theory is pretty clear on the advantages of shareholder capitalism, in which there is no separation between the ownership of businesses and its decision-making. The benefits of the price mechanism, in which economic actors compete with each other for advantage, have been with us since Adam Smith famously wrote, 'It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.' Thus selfish people acting in their own interest and controlling their own capital produce benefits for society as a whole.

"However, Smith recognized that when managers were separated from capital, a very different picture emerged. 'The directors of such companies ... being the managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance ... Negligence and profusion must always prevail, more or less, in the management of such a company.'"^[4]

Not only does short-term incentive compensation provide managers with outsized rewards; it also results in increased C-suite turnover by removing any interest in the company's long-term health – which is the very purpose for which incentive Options were designed. Trustworthy companies, by contrast, perform well over the long term (see <http://www.trustworthycorporations.com/>). None of the companies on the list offer a high ratio of incentive compensation.

Listed in Table II are those companies which have excessive C-suite compensation compared to their industry peers, and an Accounting & Governance Risk (AGR[®]) ranking in the bottom decile.

It is incumbent on us to take a more active role in compensation issues. I encourage stakeholders in these companies to realign their executives' compensation and focus on management goals that will provide Bang for your Buck before the decade is over.

[1] "The Big Zero," *The New York Times*, December 28, 2009

[2] "S&P 500 Stock Compensation: Running Out Of Options," *The Analyst's Accounting Observer*, Vol. 18, No. 11, August 26, 2009

[3] "Why Has CEO Pay Increased so Much?," Xavier Babaix and Augustin Landier, MIT Department of Economics Working Paper No. 06-13, May 8, 2006

[4] "Back to shareholder capitalism!," Martin Hutchinson, *The Bear's Lair*, January 11, 2010

Table II
U.S. Companies with Excessive Incentive Compensation
and Poor Accounting & Governance Risk Ranking

Company Name	Ticker	AGR® Rating	AGR Percentile	Company Name	Ticker	AGR® Rating	AGR Percentile
Aaron's, Inc.	AAN	Very Aggressive	2	Lender Processing Services, Inc.	LPS	Very Aggressive	6
Abbott Laboratories	ABT	Very Aggressive	9	Macrovision Solutions Corporation	ROVI	Very Aggressive	3
Aetna Inc.	AET	Very Aggressive	5	Manitowoc Company, Inc.	MTW	Very Aggressive	1
Altria Group, Inc.	MO	Very Aggressive	1	Mariner Energy, Inc.	ME	Very Aggressive	3
American Capital Ltd.	ACAS	Very Aggressive	1	Marriott International, Inc.	MAR	Very Aggressive	8
American Express Company	AXP	Very Aggressive	1	Marshall & Ilsley Corporation	MI	Very Aggressive	9
American International Group, Inc.	AIG	Very Aggressive	1	McKesson Corporation	MCK	Very Aggressive	5
ArvinMeritor, Inc.	ARM	Very Aggressive	3	Medtronic, Inc.	MDT	Very Aggressive	2
Atlas Energy, Inc.	ATLS	Very Aggressive	9	MEMC Electronic Materials, Inc.	WFR	Very Aggressive	8
Atlas Pipeline Partners, L.P.	APL	Very Aggressive	8	Merge Healthcare Inc.	MRGE	Very Aggressive	9
BB&T Corporation	BBT	Very Aggressive	10	Mylan Inc.	MYL	Very Aggressive	2
Becton, Dickinson and Co.	BDX	Very Aggressive	9	New York Community Bancorp, Inc.	NYB	Very Aggressive	9
BorgWarner Inc.	BWA	Very Aggressive	9	Newmont Mining Corporation	NEM	Very Aggressive	4
Boston Scientific Corporation	BSX	Very Aggressive	3	NIKE, Inc.	NKE	Very Aggressive	9
Broadpoint Securities, Inc.	BPSG	Very Aggressive	3	Northwest Natural Gas	NWN	Very Aggressive	9
Brocade Communications Systems, Inc.	BRCD	Very Aggressive	9	ONEOK, Inc.	OKE	Very Aggressive	6
Buckeye GP Holdings L.P.	BGH	Very Aggressive	10	OSI Pharmaceuticals, Inc.	OSIP	Very Aggressive	4
CA, Inc.	CA	Very Aggressive	3	Palm, Inc.	PALM	Very Aggressive	5
Carlisle Companies, Inc.	CSL	Very Aggressive	7	Par Pharmaceutical Companies, Inc.	PRX	Very Aggressive	7
Cephalon, Inc.	CEPH	Very Aggressive	5	Pfizer Inc.	PFE	Very Aggressive	2
Chesapeake Energy Corporation	CHK	Very Aggressive	4	Phase Forward Incorporated	PFWD	Very Aggressive	10
Chevron Corporation	CVX	Very Aggressive	6	Plum Creek Timber Co. Inc.	PCL	Very Aggressive	5
Citigroup Inc.	C	Very Aggressive	2	PNC Financial Services	PNC	Very Aggressive	1
Clinical Data, Inc.	CLDA	Very Aggressive	2	Pride International, Inc.	PDE	Very Aggressive	10
Computer Sciences Corporation	CSC	Very Aggressive	10	ProLogis	PLD	Very Aggressive	4
Constellation Energy Group, Inc.	CEG	Very Aggressive	5	Pulte Homes, Inc.	PHM	Very Aggressive	3
Covance Inc.	CVD	Very Aggressive	4	Quiksilver, Inc.	ZQK	Very Aggressive	10
CVS Caremark Corporation	CVS	Very Aggressive	4	Rigel Pharmaceuticals, Inc.	RIGL	Very Aggressive	6
Deckers Outdoor Corporation	DECK	Very Aggressive	4	RRI Energy, Inc.	RRI	Very Aggressive	6
Delta Air Lines, Inc.	DAL	Very Aggressive	6	Ruby Tuesday, Inc.	RT	Very Aggressive	10
Eaton Corporation	ETN	Very Aggressive	7	SanDisk Corporation	SNDK	Very Aggressive	1
eBay Inc.	EBAY	Very Aggressive	6	Sequenom, Inc.	SQNM	Very Aggressive	4
EMC Corporation	EMC	Very Aggressive	9	Sigma Designs, Inc.	SIGM	Very Aggressive	7
Exelon Corporation	EXC	Very Aggressive	9	Sirius XM Radio Inc.	SIRI	Very Aggressive	9
Federal-Mogul Corporation	FDML	Very Aggressive	4	Solutia Inc.	SOA	Very Aggressive	5
Fidelity National Information Services	FIS	Very Aggressive	2	Sotheby's	BID	Very Aggressive	7
Fiserv, Inc.	FISV	Very Aggressive	1	Starbucks Corporation	SBUX	Very Aggressive	4
Ford Motor Company	F	Very Aggressive	7	SUPERVALU INC.	SVU	Very Aggressive	4

General Mills, Inc.	GIS	Very Aggressive	5	Synovus Financial Corp.	SNV	Very Aggressive	9
Genzyme Corporation	GENZ	Very Aggressive	8	T-3 Energy Services, Inc.	TTES	Very Aggressive	10
Gilead Sciences, Inc.	GILD	Very Aggressive	5	TD Ameritrade Holding Corp.	AMTD	Very Aggressive	7
Google Inc.	GOOG	Very Aggressive	3	Tenet Healthcare Corporation	THC	Very Aggressive	7
Halliburton Company	HAL	Very Aggressive	9	Terex Corporation	TEX	Very Aggressive	6
Hanesbrands Inc.	HBI	Very Aggressive	5	The Allstate Corporation	ALL	Very Aggressive	6
Harley-Davidson, Inc.	HOG	Very Aggressive	7	The Bank of New York Mellon Corporation	BK	Very Aggressive	1
Harman International Industries Inc./DE/	HAR	Very Aggressive	2	The Dow Chemical Company	DO W	Very Aggressive	2
Hartford Financial Services	HIG	Very Aggressive	1	The Middleby Corporation	MID D	Very Aggressive	6
Hertz Global Holdings, Inc.	HTZ	Very Aggressive	8	The Mosaic Company	MOS	Very Aggressive	4
Hertz Global Holdings, Inc.	HTZ	Very Aggressive	8	The New York Times Company	NYT	Very Aggressive	5
Hewlett-Packard Company	HPQ	Very Aggressive	3	The Talbots, Inc.	TLB	Very Aggressive	1
IAC/InterActiveCorp	IACI	Very Aggressive	5	The Western Union Company	WU	Very Aggressive	4
Iconix Brand Group, Inc.	ICON	Very Aggressive	1	Total System Services, Inc.	TSS	Very Aggressive	7
IHS Inc.	IHS	Very Aggressive	3	Trustmark Corporation	TRM K	Very Aggressive	8
Intel Corporation	INTC	Very Aggressive	9	Ultra Petroleum Corp.	UPL	Very Aggressive	6
International Business Machines Corp.	IBM	Very Aggressive	4	Valeant Pharmaceuticals International	VRX	Very Aggressive	2
International Paper Company	IP	Very Aggressive	10	Ventas, Inc.	VTR	Very Aggressive	6
International Rectifier Corporation	IRF	Very Aggressive	5	Verizon Communications Inc.	VZ	Very Aggressive	3
Invitrogen Corporation	LIFE	Very Aggressive	4	Vertex Pharmaceuticals Incorporated	VRT X	Very Aggressive	4
Janus Capital Group Inc.	JNS	Very Aggressive	8	Wal-Mart Stores, Inc.	WM T	Very Aggressive	2
Johnson Controls, Inc.	JCI	Very Aggressive	8	Wells Fargo & Company	WFC	Very Aggressive	1
JPMorgan Chase & Co.	JPM	Very Aggressive	3	Wendy's Arby's Group Inc.	WEN	Very Aggressive	8
K-Swiss Inc.	KSWS	Very Aggressive	4	WestAmerica Bancorp.	WAB C	Very Aggressive	1
Kinetic Concepts, Inc.	KCI	Very Aggressive	3	White Mountains Insurance Group, Ltd.	WT M	Very Aggressive	7
King Pharmaceuticals, Inc.	KG	Very Aggressive	3	Wilmington Trust Corporation	WL	Very Aggressive	5
Kraft Foods Inc.	KFT	Very Aggressive	9	World Fuel Services Corporation	INT	Very Aggressive	8

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