

Executive Compensation and Its Effects on Consumer Behavior and Brand Loyalty

William D. Hancock, Jacksonville University

Richard Murphy, Jacksonville University

Hassan Pordeli, Jacksonville University

ABSTRACT

The focus of this paper is to examine and discuss CEO Compensation and the Affects on Consumer Behavior and Brand Loyalty. This will be reviewed through research in the Health Care and the Financial Services Industries.

Keywords: Executive Compensation, Consumer Behavior, Brand Loyalty, Executive performance, Cash Bonuses, Stock Shares, Stock Options

INTRODUCTION

Executive Compensation is how many top executives of large corporations and management firms receive pay. Most compensation packages are a mix of base salary, cash bonuses, stock shares and stock options. Other benefits that are included in the executive compensation packages are club memberships, security guards and use of the corporate jet for personal travel. This paper will discuss several important factors that influence Executive Compensation and will try to seek to understand how compensation packages are planned and executed in today's corporate environment. This paper will search for alternatives in executive compensation that are mutually beneficial to both the executive and the company. This paper will examine the tremendous growth of executive compensation in today's environment as it pertains to company performance; and how executive compensation is not really tied to what is best for the company or stockholder. This paper will analyze the current supply of executives in the market and try to understand if the shareholder or firm is getting what they are paying for in executive performance. This paper will discuss how Executive Compensation affects Consumer Behavior and what the implications is on Brand Loyalty.

What is Executive Compensation?

Executive Compensation and director compensation over the past three decades have dramatically risen beyond the rising levels of an average worker's wage. The Board of Directors has the sole responsibility for the dramatic increase in executive compensation levels of pay and they are solely responsible for correcting this miss alignment to the CEO and the board of directors must re-align themselves back to their fiduciary responsibility to the shareholder. "While various committees or human resource departments will usually be delegated the task of setting pay levels, a particular problem arises for executive compensation. When responsibility

for executive compensation levels is ultimately the executives', there could be, what management scientists call, significant agency costs" (Wikipedia, 2008).

In most modern US companies and corporations, the CEO and other top executives are paid a base salary plus short-term incentive bonuses. This type of executive compensation package is referred to as Total Cash Compensation. Short-term incentives usually are formula-driven and have some performance criteria attached depending on the role of the executive. (Wikipedia, 2008) Many CEO compensation packages are based on incremental profitability and revenue growth based on decisions made by the board of directors. Bonuses can and are rewarded to CEO's in an after the fact and often as it may seem to the whim of the board of directors.

"Executives may also be compensated with a mixture of cash and shares of the company which are almost always subject to vesting restrictions (a long-term incentive). To be considered a long-term incentive the measurement period must be in excess of one year (3-5 years is common)" (Wikipedia, 2008).

How Executive Compensation is used in Business?

Vesting can be either time or performance or both. Significantly other parts of the executive compensation package include such perks as a generous retirement plan, health insurance for the retiring CEO and spouse for life, a driver for work and personal life, use of the corporate jet for work and personal travel and a interest free loan for the purchase of a home in the city of the company's headquarters. Stock options have played a major role in executive compensation due to supports believe that, " stock options align the interest of CEOs to those of shareholders, since options are valuable only if the stock price remains above the option's strike price. Stock options are now counted as a corporate expense (non-cash), which impacts a company's income statement and makes the distribution of options more transparent to shareholders" (Wikipedia, 2008).s Critics of the stock option plan say that the board of directors often grant excessively and the invite management to abuse such options plans to artificially inflate revenue numbers so as to strike the price when it is a the highest price so as to make a windfall on their executive options. Most critics know that the strike price for the CEO options is quite different from the lower level managers. An example of this would be that a middle manager receives a set of 10,000 options at the strike price of \$55 dollars a share and the CEO would receive 1,000,000 shares at a strike price of \$15 dollars a share when the current trading price is \$55 dollars a share. This inequality gave rise to a new set of restricted stock reward, where the executives are also compensated with this type of stock but the executive that cannot be sold until certain conditions are met and has the same value as the market price of the stock at the time of the grant. (Wikipedia, 2008) More and more companies have gone to this type of compensation due to the fact that shareholders are increasingly getting involved with executive compensation and how it is awarded to CEOs. The restricted stock plans also have its detractors due to the fact that even if the stock price falls the restricted stock reward has value.

Strategies to Compensate Executives

The 10 steps to CEO Compensation

1. Rely on tally sheets to support executive compensation decision-making. Tally sheets present the cost to the organization of each element of the executive compensation package.
2. Identify and address any undisclosed executive compensation arrangements. Specifically, you should address arrangements that have not been communicated to the board or that have not been formally approved. These types of arrangements have potential to be unreasonable or cause embarrassment to the organization if made public.
3. Provide appropriate disclosure to the full board regarding executive compensation program design and decisions. The organization is well-served if all board members understand the components and value of the compensation program.
4. Review potential “image” issues related to executive compensation. Assess the business justification for special or highly visible program components.
5. Review high-cost program components in terms of their anticipated benefit to the organization. Specifically SERPs, retention awards, long term incentive programs, forgivable loans, and severance packages that is excessive.
6. Enhance the committee’s independence. Avoid appointing members who have financial conflicts or close relationships with executives and limit the involvement of senior executives to committee staff roles with appropriate recusal procedures.
7. Evaluate the independence of the compensation consultant. Approach with caution the use of firms that provide other significant services to the organization or its affiliates. The committee alone should directly retain its consultant/advisers and evaluate whether they have major conflicts of a relationship.
8. Review procedures and practices related to executive expenses reimbursement payments. Ensure that compliance with established financial control systems, current tax regulations and Form 990 requirements.
9. Prepare to respond proactively to media questioning regarding executive compensation. Prepare a comprehensive public relations and communications strategies. Develop supporting materials. Identify and prepare a designated spokesperson.
10. Ensure that the necessary program documentation is in place. Include a committee charter, a compensation philosophy. Have competitive assessment reports. Policies and procedures, especially those related to conflict of interest and expense reimbursement. Lastly the minutes if the committee deliberations and decisions. (Sullivan, 2008)

Who is Fighting Executive Compensation?

Executive compensation tally sheets are on the rise due to the ever-increasing regulatory oversight of boards and especially the compensation committee. Organizations need to be fully informed when making executive

compensation decisions. Disclosing base-pay and only perhaps bonuses- is no longer sufficient. (Cohn, 2008) Committees need to understand every component of their executive's compensation including: cash (base salary, bonuses, severance payments, paid-time off). Statutory and broad based benefits (social security, unemployment, medical, life insurance, qualified pensions). Supplemental/executive benefits (SERP plans, supplemental life insurance, additional paid time off, long-term care etc). Perquisites (automobile allowances, club memberships, housing allowances, legal assistance, etc). (Cohn, 2008)

With executive compensation at an all time high shareholders are set to increase their attack on executive pay. Human resources executives may be in for a pounding this proxy season as shareholders become more vocal than ever about executive compensation. (Marques, Shareholders Set To Increase Their Attack on Executive Pay, 2008) With the Securities and Exchange Commission requiring greater disclosure of executive compensation, shareholders now can see more clearly how CEOs are being compensated.

“HR executives should be prepared to not only justify their CEO's pay, but to take the time with the shareholders and explain how it's determined, Johnson says. Companies that are offering perks are sure to be targeted.” (Marques, Shareholders Set To Increase Their Attack on Executive Pay, 2008)

Shareholders have filed 90 “say no to pay” proposals this year up from the 52 proposals the year before. Shareholders are expected to continue with the SEC to press companies to adequately disclose what performance targets they are using to determine their executives' compensation packages. (Marques, Shareholders Set To Increase Their Attack on Executive Pay, 2008) There seems to be a great push by the shareholder to make sure that CEOs do not receive another dollar for services other than what they are providing in regard to executive compensation.

Analyzing Current Pay Levels for Executives

Executive compensation by numbers, during 2003 about half of Fortune 500 CEO compensation was in cash pay and bonuses, and the other half invested restricted stock, and gains from exercised stock options according to Forbes magazine. (Forbes, 2003) “The typical salary in the top of the list is \$1 million to \$3 million; the typical top cash bonus is \$10 million to \$15 million. The highest stock bonus was around \$20 million and the highest option exercise has been in the range of \$100 million to \$200 million.” (Forbes, 2003) Current figures from 2007 a CEO for a free standing hospital received average total compensation of \$367,000.00 dollars up 6% from 2006. (Modern Healthcare, 2007) CEO of a company with net revenues less than \$1 billion received a total compensation package of \$625,000.00 dollars up 5.6% from the presiding year. CEOs of a company with more than a \$1 billion in revenues received a total compensation package worth

\$1,217,000.00 dollars a 7.4% increase from 2006. (Modern Healthcare, 2007) Also a dramatic increase in CEO pay has been seen in the Health Care sector, Insures and Specialty Care Providers. Alan Miller CEO of Universal Health Services received \$13,155,952.00 dollars total executive compensation up 19.3% from year 2006. H. Edward Hanway of Cigna Corp. received at total compensation package of \$29,471,800.00 dollars up 17.9% from 2006. Dale Wolf of Coventry Health Care received total compensation of \$13,920,141.00 dollars up 12.1% from the year before. Paul Ormond of Manor Care received total compensation of \$22,494,243.00 dollars up 18% from the preceding year of 2006. (Modern Healthcare, 2007) It is amazing how much executive compensation has gone up just in the last 5 years. Many shareholders have vowed to take part in pulling back the reins on the compensation committee to keep things more in line with the shareholders' best interests. Several steps have been taken by institutional investors but it seems that the Golden Parachute still exists today.

Even if you flame out on Wall Street, you still get to keep the money. That is one of the lessons we learned from the fall of Chuck Prince and Stan O'Neal, who have bitten the dust because of Citigroup and Merrill Lynch had to take billions in losses on the securities that were overvalued on their books. (Sloan, 2007) Prince and O'Neal were heavily compensated based on those false figures to the tune of \$25.6 million for Prince and \$48 million for O'Neal what are the chances that these CEOs will return part of their ill-gotten reward back to the companies at large, likely a big fat zero. (Sloan, 2007) How about the board members giving back part of their compensation since the debacle happened on their watch and they respectively should take some responsibility in watching out for the shareholders. Each board member of Citigroup receives \$225,000 a year and Merrill board members receive \$260,000 a year on top of what they make in their day jobs. (Sloan, 2007) They should be made to give back all or at least half back because they obviously did not exercise their fiduciary right to protect the shareholder at all.

“It's an old story. We let the small people like mortgage borrowers who don't know what they're doing get wiped out, because that's the market. We talk about “creative destruction “when small employees get wacked to pay for their bosses' errors. But when it comes to the big guys who run the show and don't know what they're doing? They suffer embarrassment and bad press and loss of the company plan-but still get to laugh all the way to the bank.” (Sloan, 2007)

Executive Compensation and its Effects on Brand Loyalty

A Brand is defined as a name, term, sign, symbol or design, or combination of these, that identifies the maker or seller of a product or service. (Kotler & Armstrong, 2001) Companies receive many benefits from implementing a successful brand that entails them leveraging power,

cooperative marketing with certain partners, loyalty to the firm in consumers, positive impact on attitudes, price, stability and demand. (Morden, 1991) A brand must offer benefits to the consumer. Brand gives information about the product, speeds up consumers' decision making process before purchasing, assists in product recognition and recall by consumers, gives reassurance as a result of trust in the maker or the provider of the service and the reliability of the brand, offers value from higher quality delivered at competitive prices and consequently, the consumer receives satisfaction from the purchase of the product or service provided. (Morden, 1991)

For companies, customer loyalty enhances brand equity by lowering vulnerability to competitive marketing actions, increasing margins, increasing marketing communication effectiveness, and possibly generating more brand licensing or extension opportunities. (Keller, 1998) Brand loyalty is a construct that has both attitudinal and behavioral elements when defined as "the biased (i.e., non-random) behavioral response (i.e. purchase) expressed over time by some decision-making units with respect to one or more alternative brands out of a set of such brands, which is a function of psychological (Decision making, evaluative) process." (Jacoby & Chestnut, 1978)

In today's information age Executive Compensation information is readily available to all consumers and is covered quite thoroughly in print media as well as the evening news hour. Consumers are becoming more aware of the types of Executive Compensation packages that are being offered. Sticker shock and or the disbelief at the sheer amount of compensation that is being paid to many of the executives are the norm rather than the exception in today's economically tough times. Consumers may now reconsider their brand loyalty to said companies based on the grossly over compensating executives. This is most apparent in the Health Care and Financial Services Industries where executive salaries have risen faster than the average worker, and example of this would be Alan Miller CEO of Universal Health Services received \$13,155,952.00 dollars total executive compensation up 19.3% from year 2006. (Modern Healthcare, 2007) In the Financial Services Industry Chuck Prince and Stan O'Neal formerly of Citigroup received total compensation to the tune of \$25.6 million for Prince and \$48 million for O'Neal in their last year of employment. (Sloan, 2007) Brand loyal consumers are re-evaluating their options and may choose to leave their current Brand for an alternative that may have a better handle on Executive Compensation. Consumers are becoming more savvy and want to make sure that they are getting their monies worth with respect to the products and services that they are consuming.

CONCLUSION

This study has established the foundation for further research on the topic of Executive Compensation and Its Effects on Consumer Behavior and Brand Loyalty. Essentially, researchers could utilize the research approach in

this study to apply it to particular market segments in the future. Further research to expand the understanding of this issue with respect to many consumer markets and segments based on how Executive Compensation and Its Effects on Consumer Behavior and Brand Loyalty with respect of the core consumer may be warranted with detailed insight on socioeconomic demographics implications.

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