EXECUTIVE COMPENSATION, FIRM PERFORMANCE AND RISK IN THE FINANCIAL CRISIS PERIOD 2006-2009

Dr. Chandra Shekhar Bhatnagar

Senior Lecturer

Department of Management Studies

The University of the West Indies

St Augustine

[ChandraShekhar.Bhatnagar@sta.uwi.edu](mailto:ChandraShekhar.Bhatnagar@sta.uwi.edu)

Mr. Quinn AR Trimm

Post Graduate Student

The University of the West Indies,

St. Augustine

[qtrimm@hotmail.com](mailto:qtrimm@hotmail.com)

785-5598/655-4919

#38 Railway Road, Princes Town

Mr. Surendra Arjoon

Department of Management Studies

The University of the West Indies

St Augustine

[surendra.arjoon@sta.uwi.edu](mailto:surendra.arjoon@sta.uwi.edu)

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Chandra Shekhar Bhatnagar

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ABSTRACT

We explore the Agency and Managerial Power theories to explain the relationship among the various components of executive compensation, firm performance and unsystematic risk in the US financial sector. Institutions in the financial sector listed on the NASDAQ that have been in existence from the pre-financial crisis period January 03, 2006 to the post-financial crisis period December 272009 are examined. We find that the Agency theory does not fully explain the behavior of executives and their risk appetite. Managerial power theory fares better in this regard, as managers are focused mostly on their base salary. The data analysis shows that stock options are not significantly influenced by unsystematic risk; instead the base salary of executives has been significantly influenced by market risk and firm performance.

Keywords: Executive compensation, firm performance, market risk, unsystematic risk, Agency Theory, Managerial Theory

**I. INTRODUCTION**

Emerging from the economic debacle of the 2007-2008 financial crisis, the focus placed on executive compensation disclosed that the US CEO/worker pay gap stood at 301-1 in 2003, as compared to only 42-1 in 1982 (Matsumura & Shin, 2005). With executive compensation becoming synonymous with the ‘agency problem’ (Quinn, 1999), many scholars have concluded that equity based incentives like stock options and restricted stock can reduce agency costs by aligning CEO risk preferences and shareholders’ interests (Core et al. 2003). Furthermore, the application of performance-linked remuneration has been viewed as a tool for aligning the interests of directors and shareholders, actively encouraged by institutional investors and the Securities and Exchange Commission (SEC) in the USA (Dalton et al, 2007).

The uncertainty surrounding the Agency Theory, executive compensation, unsystematic risk, firm accounting performance motivates this study and attempts to explore the underlying relationship between them, if any.

**II. EXECUTIVE COMPENSATION, FIRM PERFORMANCE AND RISK: A RECAP**

The majority of empirical studies concerning executive compensation hinges on the Agency Theory. In this model incentive alignment as a control mechanism is achieved by making some portion of agent compensation contingent upon satisfying performance targets specified in the contract (Welbourne, Balkin, & Gomez- Mejia, 1995).

In the context of the ‘‘optimal contracting approach,’’ (Gillan, Hartzell, and Parrino, 2005), the Agency Theory explains the staggering increase in the use of stock options in ‘pay for performance’ schemes (Dalton et al, 2007) as supervisors have made use of outcome based contracts, serving them as incentives whose value is contingent on performance, such as bonuses, stock options, restricted stock, and long-term contracts (Conyon, 2006).

Bebchuk and Fried, 2006 noted that the arm’s length view of the pay setting process is “neat, tractable, and reassuring”. However ‘quality’ contracts are hampered by the myopia problems faced by several managers.

The Managerial Power Theory presents an alternative approach to optimal contracting. It postulates that the CEO has a good deal of control over the board, and this control includes the power to determine a major portion of his own compensation. In effect, this allows managers to focus a larger percentage of their compensation package away from performance based pay and toward more stable forms of pay, such as base pay (Bebchuk and Fried, 2004; Grabke-Rundell and Gomez-Mejia, 2002).

Finkelstein (1992) attributes this level of managerial power to a manager’s prestige power. He maintains that prestige power is related to a manager’s ability to absorb uncertainty from the institutional environment, and emphasizes the role of outside directorships and education as key components of prestige. These components of prestige, allow managers the appearance of achieving the company’s long term goals, and high performance in the financial markets, thus adding to their power.

Murphy, 1999 stated that most executive pay packages contain four basic components, namely, base salary, annual bonus, stock options, and long-term incentive plans (including restricted stock plans and multi-year accounting-based performance plans).

According to Demsetz & Saidenberg (1999), CEOs tend to receive a smaller fraction of their compensation as base pay and a larger fraction of same as annual bonus, long-term compensation, and options. However, Romer (2006) revealed that from 2001-2005 base pay and bonus increased their share in total compensation.

A firm’s performance measures are usually either market-based or accounting-based (Barro & Barro, 1990). Typical accounting measures include return on assets, return on equity, and net income. Murphy (1999) also highlighted that performance measures are often expressed as growth rates (e.g., EPS growth).

One of the essential features of Agency Theory is its predictions when relating firm’s performance to the use of incentive pay (Jensen & Murphy 1990). This is evidenced by Bloom & Milkovich (1998) as they confirmed a positive relationship between incentive pay and firm performance. There was also a significant amount of evidence in support of the hypothesis that firm performance positively affects executive compensation (Canarella & Nourayi, 1998).

Bloom & Milkovich (1998) suggested that organizations facing higher risk did not place greater emphasis on short-term incentive pay. In addition, higher risk firms that relied more heavily on incentive pay tend to exhibit poorer performance than higher risk firms that de-emphasized incentive pay, with relationships stronger for measures of unsystematic risk.

Gray and Cannella Jr. (1997) suggested that the compensation level (total compensation) and compensation risk is positively associated, also a negative and very significant relationship existed between unsystematic risk and CEO stock ownership.

Moving away from the risk analysis of the Agency Theory, the behavior of managers is augmented by the Prospect Theory, which predicts that individuals tend to be risk averse in a domain of gains, and relatively risk seeking in a domain of losses as when a leader is in the midst of a crisis (Tversky & Kahneman, 1991).

The remainder of the paper presents the research method and empirical findings on how the issues discussed above may be interconnected among the financial sector institutions listed on the NASDAQ. Section III details the data, variables, hypotheses and regression models. Section IV presents the empirical results. Section V concludes.

**III. RESEARCH METHOD**

A cross sectional study which relied on several data sources for secondary data collection was employed to examine the effect of firm performance and total risk on executive compensation. These included Google Finance (BA Stock), NASDAQ Index and the Securities and Exchange Commission website (SEC). The various stock price data were collected and analyzed to derive the variance of stock and its beta (unsystematic risk).

Financial Institution’s executive compensation data from the Securities and Exchange Commission website, specifically, the various companies’ 10K filings, was broken into its component parts of base salary, annual bonus, long term compensation and the value of options granted. Other firm specific and accounting data (used in deriving financial ratios) were obtained from the SEC website, specifically, the various companies’ Def 14A filings.

The periods under review were the pre-financial crisis period January 03, 2006 to December 29, 2006, the financial crisis period January 08, 2007 to December 28, 2007, January 08, 2008 to December 29, 2008 and the post-financial crisis period January 05, 2009 to December 27, 2009. A systematic random sample is taken to gain a total of 120 Financial Institutions.

Multiple regression analysis (Simultaneous Method) was used to analyze the relationship between the dependent variable (executive compensation) and independent variables (firm accounting performance, market and unsystematic risk). The data was duly treated using the first difference transformation to achieve normality.

To examine the relationship among the firm performance, total risk, total executive compensation and its constituent components, and the potency of the relationship among these variables in financial institutions, the model specified was to observe whether arelatively high level of firm performance should accompany a firm’s executive compensation package. Thus, the first hypothesis was proposed:

***Hypothesis One:***

The null Hypothesis: the regression coefficients of ROA, ROE, EPS and PE are equal to zero.

*Ho = βROA, βROE, βEPS and βPE = 0*

The alternate Hypothesis: the regression coefficients of ROA, ROE, EPS and PE are not equal to zero.

*H1 = βROA, βROE, βEPS and βPE ≠ 0*

To examine whether a relatively high level of unsystematic risk should accompany the firm’s executive compensation package, the second hypothesis was as follows:

***Hypothesis Two:***

The null Hypothesis: the regression coefficients of market risk and unsystematic risk are equal to zero.

*Ho: βMKTR and βUNSYSR = 0*

The alternate Hypothesis: the regression coefficients of market risk and unsystematic risk are not equal to zero.

*H1: βMKTR and βUNSYSR ≠ 0*

This hypothesis was tested using the same model that tested the first hypothesis.

Examining the effect of market risk and unsystematic risk on the various components of executive compensation would provide supplementary findings concerning the potency of the relationship between each component. Thus, the relationship among the factors of executive compensation and the constituent components of executive compensation was examined in each time period.

**Regression Models**

In order to test the hypotheses the parsimonious regression model was:

*Compensation= a + β1(MKTR) + β2(UNSYSR) + β3(ROA) + β4 (ROE) + β5(EPS) + β6 (PE) + εi*  (1)

In this model, the independent variables *MKTR, UNSYSR, ROA, ROE, EPS* and *PE*were represented by market risk, unsystematic risk, return on assets, return on equity, earnings per share and price to earnings, respectively. The dependent variable was total compensation.

In addition the components of executive compensation (base pay, annual bonus, long-term compensation and equity based incentives/stock options) were also analyzed as the dependent variables, listed in the models below.

*Base Pay= a + β1(MKTR) + β2(UNSYSR) + β3(ROA) + β4 (ROE) + β5(EPS) + β6 (PE) + εi*  (1.a)

*Annual Bonus= a + β1(MKTR) + β2(UNSYSR) + β3(ROA) + β4 (ROE) + β5(EPS) + β6 (PE) + εi*  (1.b)

*Long term Compensation= a + β1(MKTR) + β2(UNSYSR) + β3(ROA) + β4 (ROE) + β5(EPS) + β6 (PE) + εi*  (1.c)

*Stock Options= a + β1(MKTR) + β2(UNSYSR) + β3(ROA) + β4 (ROE) + β5(EPS) + β6 (PE) + εi*  (1.d)

**Variables**

Murphy (1999) outlined the components of executive compensation, and as such a similar definition for executive compensation was followed. Thus the dependent variable total executive compensation and its components (base pay, annual bonus, long-term compensation and equity based incentives/stock options) were analyzed.

The first independent variable was firm performance. Taking account of Murphy (1985), that the wealth of managers is implicitly tied to firm performance and that accounting based profit measures are significantly related to compensation measures such as return on assets (ROA), return on equity (ROE), earning per share (EPS) and price to earnings (PE) were used.

The second independent variable was firm risk. Considering the Market Model, risk was represented by market risk (MKTR) and unsystematic risk (UNSYSR).

**IV. EMPIRICAL RESULTS**

Descriptive statistics such as the mean, Kurtosis, maximum and minimum values of data were explored to gain an understanding of the different variables. It was noted that the base pay component of executive compensation consistently accounted for more than 50% of total compensation across the period of study, i.e. 61%, 61.63%, 66.31% and 72%, respectively for 2006 - 2009.

These findings supported the theory that managers now focus a larger percentage of their compensation package away from performance based pay and toward more stable forms of pay, such as base pay, thus moving from the agency based optimal contracting and to the Managerial Power Theory (Bebchuk and Fried, 2004).

**2006**

The accounting measures used were significant determinants of executive compensation (Barro & Barro (1990). The result of the relationship between base pay and firm performance (EPS) was highly significant as supported by Bloom & Milkovich (1998). EPS was the only significant variable for compensation and its components. These findings were supported by Murphy (1985) which stated the wealth of managers is implicitly tied to firm performance and that accounting based profit measures were significantly related to compensation.

In 2006 market risk was very significant (0.001), when bonus pay was the dependent variable. These findings were supported by Bloom & Milkovich (1998) as organizations facing higher risk did not place greater emphasis on short-term incentive pay and thus move away from the conventions of Agency Theory and its perceived risk attitudes of managers.

Unsystematic risk was very significant (0.018) with base pay as the dependent variable (Bebchuk and Fried, 2004). However, it was noted that its beta value was negative. When managers were expected to perform based on their prestige and expert power in exchange for less pay at risk (greater base pay) they were also expected to sufficiently protecting the interest of the shareholders (Appendix 1).

**2007**

While base pay continued its trend from the prior year, bonus salary, stock options and base pay appeared to be influenced by firm performance (ROA & EPS, EPS and ROE & EPS respectively), thus Hypothesis One (2007) was supported by Bloom & Milkovich (1998) as they confirmed a positive relationship between incentive pay and firm performance.

In 2007 market risk was very significant (0.001) when base pay was the dependent variable. The results suggested that executives who accept more risk in their compensation arrangements tend to be more highly compensated than those executives with less risky arrangements (Gray and Cannella Jr., 1997). The overflow of the 2006 bullish market can be attributed to these findings, as pay for performance was heavily in use at the time (Appendix 2).

**2008**

The force of the financial crisis caused a severe downturn in the economy during 2008 which resulted in a collapse of the financial markets. This evident collapse explained the findings that executive compensation was not determined by firm performance for the period.

In 2008 market risk is significant for the dependent variables total compensation, base pay, bonus and stock (0.000, 0.009, 0.000 and 0.000 respectively), however unsystematic risk was not significant for any of the dependent variables. These findings were supported by Tversky and Kahneman (1991). In light of the spiraling economy, managers did not anticipate positive gains, rather they anticipated losses to wealth, and as such they entered greater strategic risk on behalf of the firm (Appendix 3).

**2009**

With the effects of the financial crisis wearing thin and the path set to economic recovery by the US Government, both bonus salary and stock options continued to be influenced by firm performance (ROA, ROE). Total compensation also adopted this trend, influenced by firm performance (ROA) (Appendix 4).

These findings were similar to the results of 2007 and were therefore supported by Conyon, 2006; Jensen & Murphy, 1990; Bloom & Milkovich, 1998 and Gray and Cannella Jr., 1997.

**V. CONCLUSIONS**

In the bullish market for the year 2006, the results suggested that although stock options were influenced by EPS, they were not influenced by market or unsystematic risk in the pre-financial crisis period 2006; instead the base salary of executives was influenced by firm performance (ROE, EPS and PE), market and unsystematic risk. This showed that Agency Theory did not fully explain the behavior of executives and their risk appetite. Managerial Power Theory explained their behavior in 2006 as managers are focused mostly on their base salary.

In the initial crisis period 2007, bonus salary was influenced by EPS and ROA. While base pay was influenced by market risk, both base pay and bonus salary were influenced by the performance measures ROA, ROE and EPS. These findings again lend their support to the Managerial Power Theory.

In 2008 when the full effect of the crisis was felt, total compensation and its components examined (except long term compensation) were significantly influenced by market risk. Due to the downturn of the economy and seeming economic failure, none of the tested performance indicators influenced any form of compensation for the year 2008.

Finally, in 2009 with the US Government initiating the walk to economic and market recovery, both forms of risk were indentified as determinants of executive compensation, while only the performance indicators ROA and ROE influence total compensation, bonus and stock. This was the only time period examined in the study that evidenced the extensive use of performance based remuneration.

Managers are contracted based on the perceived value they can add to a company. This is reflected in their base salary – their worth at face value. Upon evidence of additional efforts (increased firm accounting performance) they are endowed with bonuses, stock options and other long term benefits. However, for the years 2006 and 2007 this study does not have the evidence to fully support the dictum of the Agency Theory. Managers did nothing to overtly jeopardize that which mattered most – their base salary. With the bullish market of 2007 managers did not appear to be “risk-seeking” and their base salaries increased. In 2008 however, the financial crisis took full effect. This caused the level of executive compensation to decline, and in 2009 managers tried to rebuild the market by taking more risk.

Agency Theory simply states that the agent will not see eye to eye with the principals so agents will do what they can (much to the disadvantage of the principals) to get their executive compensation, taking on higher levels of unsystematic risk to achieve higher ‘in the money’ stock options and working in the short-term interest of the firm to boost the firm’s accounting performance (EPS) moving past the firm’s benchmarked performance indicators and gaining a profound annual bonus as they exceeded expectations.

This study seems to lend support to the otherwise proposed Managerial Power Theory in association with executive compensation. These findings show that unsystematic risk and firm accounting performance have minimal effect on the level of executive compensation in 2007 and 2008. The Managerial Power Theory points the way for the apparent deviation from the Agency Theory in this study. According to the Managerial Power Theory, managers are given a substantial amount of power allowing them to set their executive compensation packages as they are determined by public perceptions, or ‘industry averages’.

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**APPENDICES**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **PRE-FINANCIAL CRISIS PERIOD JANUARY 03, 2006 TO DECEMBER 29, 2006** | | | | |
| Model | | Standardized Coefficients | t | Sig. |
| Beta |
| TOTAL COMPENSATION | (Constant) |  | 0.038 | 0.97 |
| EPS | 0.403 | 4.003 | 0.000 |
| BASE PAY | (Constant) |  | 0.158 | 0.875 |
| ROE | -0.415 | -3.139 | 0.002 |
| EPS | 0.536 | 6.098 | 0.000 |
| PE | -0.242 | -2.824 | 0.006 |
| MKTR | 0.275 | 3.329 | 0.001 |
| UNSYSR | -0.192 | -2.41 | 0.018 |
| BONUS PAY | (Constant) |  | 0.003 | 0.997 |
| EPS | 0.254 | 2.532 | 0.013 |
| MKTR | 0.216 | 2.288 | 0.024 |
| LONG TERM COMPENSATION | (Constant) |  | 0.065 | 0.949 |
| STOCK | (Constant) |  | 0.006 | 0.995 |
| EPS | 0.454 | 4.477 | 0.000 |

Appendix 1

Appendix 2

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **THE FINANCIAL CRISIS PERIOD JANUARY 08, 2007 TO DECEMBER 28, 2007** | | | | |
| Model | | Standardized Coefficients | t | Sig. |
| Beta |
| TOTAL COMPENSATION | (Constant) |  | 0.03 | 0.976 |
| EPS | 0.739 | 4.926 | 0.000 |
| BASE PAY | (Constant) |  | 0.107 | 0.915 |
| ROE | 0.699 | 2.02 | 0.046 |
| EPS | 0.546 | 4.115 | 0.000 |
| MKTR | 0.263 | 3.307 | 0.001 |
| BONUS | (Constant) |  | -8.98E-04 | 0.999 |
| ROA | 0.975 | 2.567 | 0.012 |
| EPS | 0.847 | 5.761 | 8.12E-08 |
| LONG TERM COMPENSATION | (Constant) |  | 0.096 | 0.923 |
| STOCK | (Constant) |  | 0.005 | 0.996 |
| EPS | 0.712 | 4.634 | 0.000 |

Appendix 3

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **THE FINANCIAL CRISIS PERIOD JANUARY 08, 2008 TO DECEMBER 29, 2008** | | | | |
| Model | | Standardized Coefficients | t | Sig. |
| Beta |
| TOTAL COMPENSATION | (Constant) |  | 0.04 | 0.968 |
| MKTR | 0.405 | 4.648 | 0.000 |
| BASE PAY | (Constant) |  | 0.078 | 0.938 |
| MKTR | 0.243 | 2.667 | 0.009 |
| BONUS | (Constant) |  | 0.012 | 0.991 |
| MKTR | 0.336 | 3.708 | 0.000 |
| LONG TERM COMPENSATION | (Constant) |  | 0.008 | 0.994 |
| STOCK | (Constant) |  | 0.026 | 0.98 |
| MKTR | 0.399 | 4.567 | 0.000 |

Appendix 4

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **THE POST-FINANCIAL CRISIS PERIOD JANUARY 05, 2009 TO DECEMBER 27, 2009.** | | | | |
| Model | | Standardized Coefficients | t | Sig. |
| Beta |
| TOTAL COMPENSATION | (Constant) |  | -8.74E-01 | 0.384 |
| ROA | 0.787 | 3.059 | 0.003 |
| MKTR | 0.304 | 3.262 | 0.002 |
| BASE PAY | (Constant) |  | -1.327 | 0.188 |
| MKTR | 0.418 | 4.569 | 0.000 |
| BONUS | (Constant) |  | -0.109 | 0.914 |
| ROA | 0.646 | 2.31 | 0.023 |
| ROE | -0.537 | -2.238 | 0.028 |
| UNSYSR | -0.269 | -2.148 | 0.034 |
| LONG TERM COMPENSATION | (Constant) |  | -0.222 | 0.825 |
| MKTR | 0.296 | 2.873 | 0.005 |
| STOCK | (Constant) |  | -0.787 | 0.433 |
| ROA | 1.13 | 4.489 | 0.000 |
| ROE | -0.968 | -4.483 | 0.000 |
| UNSYSR | -0.31 | -2.751 | 0.007 |