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Executive Pay

Paychecks on Steroids

Michael K. Ozanian Elizabeth MacDonald, 05.09.05

Basing the boss' compensation on results delivered is a noble concept. But it has a dark side.

For years the mortgage finance giant Fannie Mae delivered consistent, double-digit earnings growth. Wall Street applauded: During the five years ended last August Fannie's shares climbed a cumulative 20% versus a 16% decline in the S&P 500.

Fannie's board cheered on chief executive Franklin Raines with rich bonuses. Raines raked in $52 million from 1999 through 2003--$32 million of which came from a long-term incentive plan that guaranteed big compensation if the company achieved certain performance yardsticks, like 15% annual earnings growth.

Then Fannie's roof collapsed. Last September federal regulators discovered accounting improprieties at Fannie, triggering an estimated $9 billion profit restatement covering 2001 through June 2004. Raines was forced into early retirement in December, and Fannie's stock has plunged 20% during the past six months. Chastened, Fannie's board recently eliminated bonuses tied to financial results for its executives for 2005. Instead it substituted fuzzier targets, like progress on financing affordable housing.

It hasn't been established whether Raines manipulated the numbers to rake in a bigger paycheck. But the debacle at Fannie illustrates the potential danger of dangling a big carrot in front of the boss.

The idea of basing pay for bosses on the performance of the companies they run has been around for years. Eugene Grace, president of Bethlehem Steel in 1929, earned a $1.6 million cash bonus on a salary of $12,000 (equivalent in purchasing power today to a $17.3 million bonus on a $130,000 salary). But performance bonuses became all the rage in the 1990s. The stock market was taking off, and stock options were the currency of choice because companies did not have to expense them. Incentive plans would typically cover two or three years and incorporate such metrics as profitability and the company's stock price.

In theory, paying for performance aligns the interests of the person running the company with those of the shareholders. But just how precisely are those interests aligned? The proxy statement is often so vague it's impossible to figure out what targets were supposedly met by an executive to qualify for a bonus. Plus, it's easy to play with how you meet targets, especially earnings.

Yet a large portion of compensation is typically tied to meeting earnings goals, according to Baruch Lev, professor of accounting and finance at New York University's Stern School of Business. Generally accepted accounting principles are an art, not a science. Give a smart boss the incentive to do it, and he can push the earnings envelope to the limit--or beyond. Delphi, OfficeMax, Qwest and WorldCom are other companies that heaped big performance-based bonuses on their bosses but subsequently had to restate earnings lower after accounting shenanigans were discovered.

Paying for performance "has vastly increased the number of accounting disasters," says Paul Hodgson, a senior research associate at the Corporate Library, a corporate-governance research firm in Portland, Me. According to a 2003 study by the comptroller of New York State, between 1995 and 2002, when companies were increasingly tying bonuses to earnings, the number of earnings restatements increased from 44 to 240.

Are there any more loaded guns out there? We went looking for companies whose earnings were of low quality and whose bosses might benefit from an enhancement to earnings. "Low quality" here means a significant gap between reported earnings and so-called cash earnings. Criterion Research, a financial statement analysis firm in New York City, defines cash earnings as operating cash flow plus the effect of investments like capital expenditures and acquisitions (such as the repurchase of franchise agreements by Krispy Kreme). Low quality also applies to companies that have habitually booked restructuring charges and asset writeoffs, which often have the effect of undoing overly optimistic accounting assumptions--and overstated earnings--in earlier years. We found seven companies with poor earnings quality whose bosses received payouts in 2004 from long-term incentive plans that were more than their annual bonuses.

"We believe the accounting items we reviewed boosted earnings and could boost executive compensation based on earnings performance," says David Trainer, president of New Constructs, an equity research firm in Nashville, Tenn. New Constructs is one of three experts we consulted to gauge earnings quality. The others were Criterion Research and Corporate Library. To make the list, a company had to have a below-average earnings quality score from at least two of the three firms.

In 2003 Theodore Solso, chief executive of enginemaker Cummins, took home $4.8 million in compensation, of which $3 million came from his long-term incentive pay. The latter, according to the company's proxy statement, was earned by meeting unspecified free cash flow targets in 2001 and 2002. During that period the company's free cash flow (Cummins defines it as cash from operating and investing activities, which includes capital expenditures but excludes cash from acquisitions, among other items) soared to $94 million from $53 million.

How? Largely by dint of a $116 million cut in capital expenditures in 2002, to $90 million. Not that Cummins was going to starve its factories forever. The next year the company raised its capital spending to $111 million, which cut free cash flow to $26 million. (Cummins says it cut cap-ex to conserve cash when business slowed.) Trainer doesn't like that from 1998 through 2004 Cummins has been blowing through a lot of shareholder capital, as it has written off a total of $233 million in assets, after taxes, for things like unsuccessful joint ventures and equipment.

Trainer says Cummins also helped its free cash flow along--and its chief executive's incentive pay--during this period with its heavy use of operating leases, an off-balance-sheet financing technique. Such leases deliver all of the effects of a heavily mortgaged asset but keep a company's capital expenditures low, as a company doesn't have to shell out cash to buy the equipment or plants outright, says Charles Mulford, an accounting expert who runs the Georgia Tech Financial Analysis Lab. Trainer says the net present value of Cummins' operating leases came to $257 million at the end of last year. Cummins said its operating leases did not affect its boss' performance pay.

Charles Fote, chief executive at First Data, the outfit that owns Western Union, received a $2.8 million long-term payout in 2004. It was based on the company's stock performance versus the S&P 500 in 2000 and 2001, and return on equity in 2002 and 2003.

Criterion scores First Data in the bottom decile of earnings quality versus S&P 500 companies. Trainer is also wary that First Data has written off a total of $467 million in assets, after taxes, from 1998 through 2003. Those writeoffs had the effect of lowering the company's shareholder equity. Trainer says that in turn the writeoffs were responsible for 3.4 percentage points of First Data's 35% ROE in 2003, an improvement of 10%. ROE was used in setting its boss' pay. Did Fote give back any of his compensation that was based on earnings in those earlier years? The company didn't return calls for comment on the issue, and its filings don't specify.

All of the companies in the table on page 136 adamantly deny they are making accounting maneuvers to boost executive compensation. And they say their bookkeeping is in line with generally accepted accounting principles.

The Boost

These bosses got big performance-based payouts. Their companies reported results experts deemed of poor quality.

		2004 CEO Pay		
Chief Executive/Company	**Recent Price**	**LTIP[1] ($MIL)**	**Total ($MIL)**	**Earnings Quality Concerns**
James E Rogers/Cinergy	$40.12	$4.9	$14.6	deferred tax liabilities
Theodore M Solso/Cummins	67.34	3.0[2]	4.8[3]	off-balance-sheet financing
Charles T Fote/First Data	39.00	2.8	5.4	asset writeoffs
Norman H Wesley/Fortune Brands	86.75	4.9	16.9	stock options, asset writeoffs
G Richard Wagoner/General Motors	28.33	3.3	8.5[3]	consumer finance receivables and loans
Ray R Irani/Occidental Petroleum	68.58	7.7	64.1	writeoffs and deferred tax liabilities
Alan G Lafley/Procter & Gamble	55.21	9.9	12.1	income tax payables, receivables

Prices as of Apr. 13. [1]Long-term incentive payout. Includes amounts paid under medium-term performance plan. [3]Prior-year data. Sources: Latest available company proxy statements; Hemscott (www.hemscottdata.com); Corporate Library; Criterion Research; New Constructs; Reuters Fundamentals via FactSet Research Systems.

Statistics: Scott DeCarlo.