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Compensation practices in the lodging industry: Does top management pay affect corporate performance?

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ABSTRACT

The current study examines the relationship between executive compensation and firm performance in the U.S. lodging industry. It is not clear-cut whether performance leads to compensation or compensation drives firm performance. Our contention is that cash and lagged equity-based compensation drive the firm performance. Our findings suggest that chief executive officer's (CEO) contemporaneous cash-compensation and one-year lagged equity-compensation positively affect the accounting performance measures return on assets and Tobin's Q; but neither compensation components affects the market-performance measure, stock returns, in the lodging industry. Quantitatively similar findings are found for the chief financial officer (CFO). Further robustness test show that further lags of equity compensation of both named executives do not result in increased stock performance in the lodging industry.

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1. Introduction

Executive compensation is paid by firms to ensure adequate economic return to all stockholders of the firm. For example, while shareholders might be interested in an increase in firm value (short or long term), debt holders are interested in return of their capital with interest. Therefore, firms expect that managers will be good stewards of the firm. However, the root of the problem is that the interests of the managers might not coincide with the interests of the owners of the firm. This is the classic agency theory problem. Managers act in their own self-interest, while appearing to act in the interest of the various stakeholders of the firm. Concerted efforts have been made to structure compensation contracts to align the interests of the owners with those of the managers. This is the basic crux of the pay-for-performance literature. However, there is yet no consensus in the literature about the efficacy of this relationship (Jensen and Murphy, 1990; Duru and Iyengar, 1999). We are not yet sure if the evidence points to a pay-for-performance or perform-and-get-paid situation. In other words, it is not yet clear if executives are paid in advance with exhortation to perform or are they paid after they have performed. In many situations, the compensation contracts clearly state the benchmarks to be achieved before earning bonuses. Frequently the contracts are modified ex-post if the ex-ante benchmarks are not met.

Agency theory argues that aligning executives' personal interests with those of shareholders is crucial in alleviating the conflicting interests of these two parties and increasing the likelihood of higher firm performance (Crumley, 2008). Compensating executives with company stock is an effective tool to align their interests with owner's interests. Because executives' total compensation is linked to stock performance of the company, stock-based incentive compensation plans permit a fair risk sharing between executives and owners (Veliyath and Bishop, 1995). Previous research in the compensation literature provides evidences from both perspectives. Some studies investigate the effect of executive compensation on firm performance (Sigler and Haley, 1995; Loderer and Martin, 1997; Mehran, 1995), while others examine this relationship in the opposite direction with the presumption that financial performance is a determinant of executive compensation (Core et al., 1999; Attaway, 2000; Crumley, 2008).

In this study, we extend the existing pay-for-performance literature along many dimensions. Although most studies investigate this issue using all available publicly traded firms, there are plenty of recent studies that look at specific industries to uncover the pay-performance relationship. We focus our analysis on the U.S. lodging industry. While there are few compensation studies conducted in the restaurant industry, to the best of our knowledge, no previous study has looked at the pay-performance relationship in the U.S. lodging industry. One of the reasons hospitality researchers avoid investigating this phenomenon in the lodging industry is the limited sample size of the publicly traded U.S. lodging companies. Yet, given the different characteristics between lodging and restaurant industries, it may be misleading to interpret the findings of the previous restaurant studies in the more complex lodging

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industry. Many concerns make it difficult to extend the results of the restaurant industry-specific studies to lodging firms. First, lodging firms are more complex and larger than the restaurant firms, so they are structurally different from restaurant firms. Second, lodging chains operate in a more global business environment and therefore are exposed to a more diverse customer base and varying customer demands. Third, lodging chains have a long history of corporatization versus the restaurant chains, which entails the expectation that they have stronger corporate practices (including executive compensation contracting) than the more recently appearing restaurant chains. These distinct characteristics of the lodging firms separate them from the restaurant firms and necessitate different sets of tests to understand the pay-performance phenomenon within the dynamics of the lodging industry. In terms of the differences from the larger manufacturing firms, lodging firms are usually smaller in size (Paryani et al., 2010) and are concerned more with service qualities rather than with manufacturing qualities. Also, the high turnover rate in the lodging industry, in contrast to that of the manufacturing industry, generates a negative image in the labor market and is likely to be a deterrent factor for top executives to work in this unstable working environment. Additionally, lower compensation levels in the lodging industry lead to a potential disadvantage for lodging firms to acquire the most-talented executives in the labor market, which then is likely to result in less-than optimal firm-executive matches and likely poor firm performance. Due to these differences, lodging firms largely require different characteristics and skill sets for the executive positions. Hence, we assume that it is very likely that there exist different dynamics underlying compensation practices in the lodging industry.

While earlier research in the compensation literature focused on the chief executive officers' (CEO) compensation, most recent studies have started to include other senior executives' compensation packages (Jiang et al., 2010). Chief financial officer (CFO) is one of these top senior executives that has strong control and responsibility for the financial stability of a firm. Especially after the passage of the Sarbanes-Oxley Act of 2002, CFOs have been burdened with unprecedented legal responsibilities and have shared the risk of any corporate failure with the CEOs. Thus, CFOs can be regarded as the second most powerful executive in the corporate structure of an organization and take on a key role in the financial performance and success of any firm. Moreover, the financial decisions that the company makes involve both the involvement and approval of CFOs. In light of this argument, we propose that the increased responsibility on CFOs must be compensated with favorable pay-packages for increased firm performance. As far as the lodging industry is concerned, there has been no study that specifically investigates the CFO compensation and its relation to firm performance. Hence, the current study attempts to examine the CFO compensation with respect to firm performance in the U.S. lodging industry in addition to providing insights to the CEO pay-firm performance relationship. We expect to see a positive association between a firm's performance and CFO's compensation. Finding similar results as the CEO would suggest robustness for the impact of executive compensation on firm performance while dissimilar results suggest hierarchical differences in the pay level and firm performance, which may induce further research to scrutinize the discrepancy between CEO and CFO (and other senior executives) as it relates to firm performance.

Previous studies in the hospitality research used either only salary or salary plus bonus (cash compensation) compensation packages to investigate the so-called pay-performance relationship (Kim and Gu, 2005; Gu and Choi, 2004). The main reason for excluding stock-based compensation is primarily the lack of data. FAS 123R was issued in 2004 (became effective in 2006) and required firms to disclose individual components of executive compensation and expense stock options as of grant date. From the effective date of the FAS 123R, publicly traded U.S. firms have begun to disclose all relevant cash compensation (salary and cash bonuses) and equity compensation including restricted stocks, stock options, stock awards, and long-term pension contributions. Making use of these recently available pay components, the current study examines both the relationship between cash-compensation firm performance and stock-based compensation and firm performance using both accounting and market performance measures. We posit that accounting performance of a lodging firm is related to the cash component of the named executives' compensation, whereas market performance is related more to the equity component of the executives' compensation.[1]

2. Literature review

2.1. Agency theory

The focus of the studies on the pay-performance relationship has shifted to direct linkages between executive compensation and firm performance (Canarella and Nourayi, 2008). Therefore, many researchers have utilized an agency theory approach to examine this relationship. An agency problem in an organization occurs when the executives of the company, who run the company on behalf of the owners, pursue goals and objectives that are not consistent with those of the organization (Welbourne and Cyr, 1999). This in turn leads to conflicts with the interests of the stockholders' who own the organization (Attaway, 2000). Boyd (1994) claims that agency problems mostly occur when the agents of the organization have no interest in the financial outcomes of the decisions made. In addition to this, Welbourne and Cyr (1999) add that agency problems arise because risk preferences of agents are different from those of principals, which leads to decisions that are less than optimal. They further continue that this fact leads to two assumptions. First, agents are risk averse and avoid taking risks because they follow personal goals; and second, owners are risk neutral and they pursue organizational goals. Therefore, it could be argued that though the agents and owners are partners collaborating for the same purposes, they act differently when it comes to risk taking (Huang et al., 2004). The varying risk taking propensities further extend the gap between executives' and owners' interests. In order to lessen this gap among the two parties' interests, agents' incentives must be aligned with those of shareholders' through compensation arrangements that reward agents on the basis of firm performance (Canarella and Nourayi, 2008; Murphy, 1985; Glassman and Rhoades, 1980; Welbourne and Cyr, 1999). In order to mitigate harmful effects of agency theory, stock-based incentives have been offered as an alternative pay method to top-level executives. Some companies even forced their executives to own company shares (Kay, 1999). One study showed that large companies, for example, J.C Penney, require that their CEOs maintain a large amount of company stock, as large as seven times their base salaries (Kay, 1999). Likewise, Tosi and Gomez-Mejia (1994) and Crumley (2008) stated that one-way of incentive alignment is stock ownership, which serves to create a situation in which the goals of the executives are similar to those of owners. These practices are in line with the propositions of outcome-based contractual agreements as suggested by the proponents of positivism stream of agency theory (Eisenhardt, 1989). This proposition argues that outcome-based contracts limit the agent opportunism by co-aligning the interests of the agents and the principals on the same grounds because the rewards of both

[1] Equity-compensation is used interchangeably with stock-compensation throughout the paper.

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