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LINKAGES BETWEEN CEO COMPENSATION, NET INCOME AND STOCK PRICES

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ABSTRACT

Calculating the economic value that a CEO contributes to the worth of a corporation is seemingly a moot point. However, recent reporting changes regarding executive compensation has attracted widespread investor and public attention to this subject. Regardless of the industry, place in the economic/industry cycle the issue of analyzing if a CEO's annual compensation is directly correlated to yearly increases or decreases in an enterprise's value is a topic that few outside the boards of directors' corporate compensation committees clearly understand. The purpose of this 2015 quantitative research project was to follow-up a previous research project conducted in 2011 to investigate if any linkage exists between the annual salaries of the CEOs of public traded firms in the State of Wisconsin, USA and increases/decreases in the price of their corporations' stock price and net income. The results of the 2015 research indicate that statistically significant relationships existed between the annual salaries of the CEOs of public traded firms in the State of Wisconsin, USA and increases/decreases in the price of their corporations' stock price and net income. This conclusion is different from the 2011 research findings.

JEL: M120

KEYWORDS: CEO, Compensation, Employee Participation, Executive Compensation, Executives, Personnel

INTRODUCTION

The author of this study, a resident of Wisconsin selected the State of Wisconsin as a micro-study due to the number of Fortune 1000 firms (23) and Fortune 500 companies (8 - 18th highest in the United States) and their corporate headquarters. Some well-known corporations include Fiserv, Harley-Davidson, Johnson Controls, Kohl's, Manpower, Northwestern Mutual and Rockwell Automation. In 2011, the author conducted an analysis of public traded firms (Keller, 2013) to ascertain if statistically significant correlations existed between the compensation of corporate executives of 48 public traded firms and the stock prices and net incomes of their firms prior to the onset of the Great Recession in 2008 and during the economic recovery in 2010. The chief outcomes from that research showed that there was no statistically significant correlation between the compensation of corporate executives of 48 public traded firms in the state of Wisconsin and the net incomes and stock prices of their firms in 2008. In 2010, there was no statistically significant correlation between the compensation of corporate executives of 48 public traded firms in the study and the stock prices of their firms. However, there was a statistically significant correlation between the compensation of these executives and the net incomes of their firms.

The purpose of the 2015 study was to follow-up the 2011 investigation, which was one of the recommendations from the 2011 research paper. Another goal of the 2015 research was to assess to what degree CEO compensation changed when the American and economy experienced a surge in stock price and revenue increases. Corporate stock and financial results of the same firms' from 2010 and 2014 were compared to discover if any statistically significant changes occurred regarding the effect of executive compensation and corporate performance. The 2010 study included 48 corporations and their CEOs; the

2014 research evaluated 33 corporations. The reason for the disparity was due to turnover in some of the firms' CEOs. In the 2015 research, the same CEOs evaluated in 2011 are studied. The time covered in the 2015 research project is unique as it takes into account corporate stock price, net incomes and CEO compensation variances between the Great Recession and record post Great Recession recovery periods.

Total compensation for CEOs continued to grow during the course of the years of this series of studies from 2008 – 2014 “pushed up by the value of executive stock awards. The median compensation for the heads of Standard & Poor's 500 companies rose to a record \$10.6 million, up from \$10.5 million the year before” (Jsonline, 2015, para 12). The consistent, widening gap between executive and employee compensation prompted the Securities and Exchange Commission (SEC) in April 2015 “to propose rules to require companies to disclose the relationship between executive compensation and the financial performance of a company. The proposed rules, which would implement a requirement mandated by the Dodd-Frank Act, would provide greater transparency and allow shareholders to be better informed when they vote to elect directors and in connection with advisory votes on executive compensation” (SEC, 2015, para. 1).

One of the prominent results of the author's 2011 study of the effect of executive compensation and changes in a firm's stock price and net income in 2010 was that there was no statistically significant correlation between executive compensation and a firm's stock price and a statistically significant correlation between executive compensation and a firm's net income. Given the notable increases in CEOs' compensation tied to an enterprise's stock price; the author conducted a follow-up research study on the same public traded firms and their CEOs (who were still in charge of the corporations) using the identical methodology as used in 2011. This research effort continues to scrutinize the question; do the actions of a CEO have a direct connection to corporate financial results? The Literature Review explored four threads, management's impact on corporate performance, CEO compensation trends, CEO and employee pay disparities and an assessment of CEO compensation developments in Wisconsin.

LITERATURE REVIEW

Hubbard (2006) cited the work of Alfred Chandler Jr. and David Landes who asserted that professional management was the key factor for the United States' rise to economic prominence compared to its European rivals. “Through the microeconomic perspective, management is, at heart, a choice made by each firm” (p. 30). An influential study by Bloom and Van Reenen (2006) of more than 700 manufacturing companies in Great Britain, France, Germany and the United States found that the approach taken by corporate leaders was the foremost management influence on enterprise performance. Those firms with superior management were associated with higher productivity, return on equity and market capitalization. Bloom and Van Reenen (2007) followed up their study of 700 European firms with an expanded research project encompassing more than 4,000 American, European and Asian businesses. Bloom and Van Reenen (2007) research further reinforced their 2006 findings. Bloom and Van Reenen also determined there was no single management practice that provided the key to improved corporate performance. Rather, it was the average score of 18 management practices grouped into “four areas: *operations* (three practices), *monitoring* (five practices), *targets* (five practices), and *incentives* (five practices)” (p. 1361) when compared to an enterprise's economic success that provided the most accurate indicator of success. One micro study conducted (Keller, 2009) applied Bloom and Van Reenen's methodology on for-profit corporations in southeast Wisconsin in late 2008. The results from this scholarship showed that management practices did not have a statistically significant impact on the economic performance of for-profit firms with the exception of one ownership type.

Jarque and Muth (2013) examined how CEO remuneration packages were constructed. In their study, the authors could not clearly determine what specific metric linked an executive's compensation and the performance of his/her firm. Additionally, Jarque and Muth found that the study of executive compensation is constrained by the availability of data. Their study revealed that: “executive compensation packages of

most executives include stock and option grants on their own firm's shares, which typically come with requirements that they be held by the executive for at least three or four years. First, the compensation requires that are reported by firms (and are readily available to the press and researchers) are a combination of both expected value of compensation (for deferred compensation in the form of restricted stock and option grants that are not convertible into cash right away) and realized value (salaries, bonus payments, and perquisites). Second, a given year's compensation package provides income for several years to follow, since the CEO will be able to realize gains from selling and exercising stock and option grants once their vesting restrictions expire" (p. 252).

Ganor (2013) discovered a statistically significant correlation between corporate cash retention and CEO compensation which increased from 2008 – 2010. "The accumulation of cash contributed to an average growth of 10 percent in the CEO's annual compensation is associated with an average of 3 percent increase in the firm's money holdings and that the correlation between CEO compensation and cash holdings became statistically significant from 2008 through 2010" (p. 107). DiPrete, Eirich, and Pittinsky (2010) may have explained the "invisible hand" influencing the escalation of executive compensation. They assert that the impact of disproportionate pay enlargements for a relatively small number of executives in a given year/s proliferates to peer industry groups. Comparing peer industry averages is a frequently used method by boards of directors to gauge and calculate executive pay packages. DiPrete et al. coined the term "CEO leapfrogging" as one way to comprehend the consistent annual CEO pay escalation since the early 1990s.

The August, 2015 unemployment rate in the United States was 5.1 percent, the lowest rate since August 2007 (United States Department of Labor, 2015a). The National Conference of State Legislatures (2015) reported an unemployment rate for the State of Wisconsin (the region of interest of this series of studies) of 4.5 percent in August 2015, the lowest since 2008. The significant job and economic gains generated during the recovery after the Great Recession have fueled immense gains in wealth and executive compensation. Much research has focused on wage growth, the growing disparity between executive compensation and wages paid to non-executive employees and what if any legislation needs to be taken to moderate the pay ratio disparity between CEOs and workers. The Harvard Business School conducted research to discover what Americans thought about the wage discrepancy between CEOs and average workers. The results of the study found that Americans misjudged the salary gap significantly by a factor of nearly 116 times (30 vs. 350 (Ferdman, 2015)). According to the AFL-CIO's annual pay gap analysis, the average Fortune 500 CEO in the United States in 2013 made more than \$12 million per year; however, the multiple more than doubles when compared to minimum wage workers; the average CEO in 2013 out-earned this group 774 times (Dill, 2015). The national average wage (non-CEO) index for 2013 was \$44,888.16. The index is 1.28 percent higher than the index for 2012 (Social Security Administration, 2015). Another perspective that summarizes the wage disparity trend was reported by Harwell and McGregor (2015); "Fifty years ago, the typical chief executive made \$20 for every dollar a worker made; now, that gap is more than \$300 to \$1, and it's growing" (para. 4).

Shin (2014) sought to determine some influences that contributed to the widening wage gap. He concluded that the demise of unionization was a key factor. "In 2014, the union membership rate was 11.1 percent compared to 1983, the first year for which comparable union data are available, the union membership rate was 20.1 percent, and there were 17.7 million union workers" (U.S. Department of Labor, 2015b, para. 1). Shin asserted that unions a) not only contributed to representing workers' economic influence but also impacted executive compensation as a "moral pillar" (p. 1339) to balance standards about evenhandedness and fairness and b) the decline of unions left few if any restraints on tempering the wage fissure. Since 1999, Wisconsin's economy has fared well.

According to Fortune (2014) Wisconsin was one of nine states with the most number of companies in the Fortune 500. According to the Wisconsin Department of Revenue (2014): "The Wisconsin economy grew at a moderate pace in 2013 and will gain steam in 2014. The Wisconsin economy, as measured by personal

income, grew 3.9% in 2012, just below the 4.2% growth nationwide. Wisconsin personal income should post growth of 2.9% in 2013 and will grow 4.0% in 2014” (p. 1). In 2010 in Wisconsin, the typical pay of a public traded Wisconsin company that was part of the researcher’s study was \$4.1 million. In 2014, the same group of CEOs’ compensation was \$4.3 million, an increase of 4 percent. In contrast, the average worker in Wisconsin made \$808.00 per week or \$42,016 per year (U.S. Department of Labor (2015c) compared to \$39,156 in 2010 (an increase of 6 percent). The pay disparity between Wisconsin CEOs to the average employee in 2014 was 103:1 a 3 percent increase compared to the 99:1 ratio in 2010 and still significantly lower pay differential than national averages.

The scholarly and popular literature review continues to point to the enlarging chasm between CEO compensation and worker wages. While the causes for the gulf continues to be investigated, the key foundational questions that remain are: a) to what extent do CEOs (i.e. management) have an economic impact on their firms’ stock prices and net incomes and is there a relationship between CEO compensation and changes in their firms stock prices and net incomes? This study continued the investigation of these questions focused on public traded companies in the state of Wisconsin.

METHODOLOGY

The problem addressed in this part of the quantitative micro-study was to determine if a linkage existed between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin and increases/decreases in the value of their corporations’ stock price and net income. The 2011 study analyzed 48 corporations and their CEOs; this 2015 study evaluated 33 corporations. The reason for the disparity was due to turnover in certain firms’ CEOs. The 2015 research evaluated only the same CEOs who were in the 2011 investigation. In this study, salary, stock prices and net income data came from public available sources, e.g. 10K and DEFA14K reports filed with the SEC and MarketWatch.com. The basic hypotheses that guided the 2011 study guided this 2015 study. Below are two sets of null and alternative hypotheses that.

Hypotheses

H1o. There is no statistically significant linkage between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, and increases/decreases in the price of their corporations’ stock prices in 2014.

H1a. There is a statistically significant linkage between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, and increases/decreases in the price of their corporations’ stock prices in 2014.

H2o. There is no statistically significant linkage between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, and increases/decreases in the net income of their corporations’ in 2014.

H2a. There is a statistically significant linkage between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, and increases/decreases in the net income of their corporations’ in 2014.

RESULTS AND DISCUSSION

The researcher used a t-test-paired two sample for means to analyze the data. A 5 percent level of significance determined whether to accept or reject Null Hypothesis 1: There is no statistically significant linkage between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, USA and increases/decreases in the price of their corporations’ stock prices in 2014. The data analysis results

found that there was a statistically significant relationship between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, USA and increases/decreases in the price of their corporations' stock prices in 2014. With a t critical two-tail value of 2.04 needed at the 5 percent level and a t value of 7.08 was found which is well below the 5 percent level of significance (.0000000247). Thus Null Hypothesis 1 is rejected (Table 1) and Alternative Hypothesis 1 is accepted. The researcher also used a t-test-paired two sample for means to analyze the data to determine whether to accept or reject Null Hypothesis 2: There is no statistically significant linkage between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, and increases/decreases in the net income of their corporations' in 2014. The data analysis results found that there was a statistically significant linkage between the annual total compensation of the CEOs of 33 public traded firms in the State of Wisconsin, USA and increases/decreases in the corporation's stock prices in 2014. With a t critical two-tailed value of 2.04 was needed at the 5 percent level and a t value of 4.0 was found which is well below the 5 percent level of significance (.0003). Thus Null Hypothesis 2 is rejected (Table 1) and Alternative Hypothesis 2 is accepted.

Table 1: Relationship of CEO Compensation to Firm's Stock Price and Net Revenue 2014

Hypothesis	T-Critical Two-Tailed	T Value Found	P Value Found	Decision
1	2.04	7.08	.0000000247***	Reject Null Accept Alternative
2	2.04	4.0	0.0003***	Reject Null Accept Alternative

This table shows the results of a t-test-Paired Two Sample for Means; a 5 percent level of significance determined whether to accept or reject Null Hypothesis 1 and 2. The numbers below the p Value Found is indicate significance at the 1, 5 and 10 percent levels respectively. The outcome of the t-tests indicated there is a statistically significant linkage between the annual salaries of the CEOs of 33 public traded firms in the State of Wisconsin, USA and increases/decreases in the price of their corporations' stock prices and net incomes in 2014. P Value found Significance Level 10, 5**, 1***.*

Additional analysis compared the findings from research conducted in 2011 with that of 2015. The researcher only compared the stock prices and net incomes of the public traded firms led by the same CEOs in 2010 and 2014. Table 2 displays the findings of this analysis.

Table 2: Comparison of Average Net Income, CEO Compensation, and Stock Price on December 31, 2010 and 2014

Average Net Income in 2010	Average Net Income in 2014	Difference
\$80,716,337	\$209,106,248	\$128,389,911 +61%
Average CEO Salary in 2010	Average CEO Salary in 2014	Difference
\$4,084,465	\$4,344,824	\$260,359 +6%
Average Stock Price in 2010	Average Stock Price in 2014	Difference
\$24.28	\$42.70	\$18.42 +43%

This table shows the extent of the recovery experienced by the United States' economy, and the 33 Wisconsin public traded firms in this 2015 research project, from the depths of the Great Recession to a growth trajectory in 2014. The average net income increased between 2010 and 2014 by \$128,389,911.00 (61 percent) and the average per share stock price also enlarged on average by \$18.42 (43 percent).

Interestingly, the average CEO total compensation package increased by \$260,359.00 or 6 percent. The 6 percent salary increase requires further inquiry considering the significant improvements in corporate net income and stock prices. In the comparison between 2010 and 2014, in 2014 12 (36 percent) CEOs received lower total compensation packages and six firms (18 percent) reported declines in net incomes. Clearly, a rebound of the national economy contributed to increases across the key parameters under investigation in this 2014 study.

A broad perspective is required when analyzing CEO pay and its connection to firm performance. Table 3 depicts comparisons from three periods. The key indicators are the relatively small salary increases (18 percent) from 2008 – 2014 compared to the very strong (61 percent) growth in net income and (56 percent) surge in the price of the firms' stocks.

Table 3: Comparison of Average Net Income, CEO Compensation, and Stock Price on December 31, 2008, 2010 And 2014

Average CEO Salary in 2008	Average CEO Salary in 2010	Difference	Average CEO Salary in 2014	Difference between 2008 and 2014
\$3,543,098.00	\$4,084,465	\$550,472 +13%	\$4,344,824	\$801,726 +18%
Average Net Income in 2008	Average Net Income in 2010	Difference	Average Net Income in 2014	Difference between 2008 and 2014
\$80,716,337	\$86,379,273	\$5,662,936 +7%	\$209,106,248	\$128,389,911 +61%
Average Stock Price in 2008	Average Stock Price in 2010	Difference	Average Stock Price in 2014	Difference between 2008 and 2014
\$17.71	\$24.70	\$6.99 +28%	\$42.70	\$24.00 +56%

This table compares the average salaries of CEOs, net incomes and stock prices of the CEOs and their firms that were the subjects of analysis in this study. The pre-Great Recession and Recovery years indicate that between 2008 and 2014 the average salary of a CEO of a public traded firm in Wisconsin increased by 18 percent, the average net income of these corporations enlarged by 61 percent and the average value of the companies' stock price grew 56 percent.

An important finding in this 2015 study was the consistent relationship between a CEO's pay and his/her effect on their firm's financial performance. The outcomes of research conducted in 2008 showed that there was no statistically significant linkage between the compensation of corporate executives of public traded companies in the state of Wisconsin and the stock prices and net incomes and of their entities in 2008. However, in 2010 while there was no statistically significant relationship between the compensation of corporate executives of 48 public traded firms in the state of Wisconsin and the price of their corporations' stock prices in 2010, there was a statistically significant relationship between the compensation of these executives and the net incomes of their corporations. This 2015 follow-up study indicated a major variance from the 2011 research indicating that there was a statistically significant relationship between the compensation of corporate executives of 33 public traded firms in the state of Wisconsin and both net incomes and stock prices.

CONCLUSION

The significant finding from this study was a major change from the 2011 research indicating that there now is a statistically significant relationship between the compensation of corporate executives of 33 public traded firms in the state of Wisconsin and both net incomes and stock prices of the companies they lead. This 2015 study found that the CEOs directly influence how a firm conducts its daily fiscal business and manages its human and capital resources. As Bloom and Van Reenan confirmed in their 2006 and 2007 studies, a bundle of 18 management practices, consistently executed directly contribute to the success (financial and operational) of a firm. The mini-longitudinal study conducted by this researcher affirmed Bloom and Van Reenan's contention.

This mini-longitudinal research also varied from the findings from the 2011 research regarding the relationship between the compensation of corporate executives of public traded companies in the state of Wisconsin and changes in the stock prices of their entities. The 2015 study found a statistically significant relationship between CEO compensation and increases in the price of their firm's stock price. Perhaps this finding is not remarkable. The numerous variables that influence the daily value of public traded firms are beyond the scope of this research. However; it is difficult to assert that the routine decisions of a rational

CEO and his/her staff and governance board have a predictable impact on the psychology of investors' buying and selling judgments. Emotions (fear and greed), economic shocks etc. all have roles in the ultimate price of a firm's perceived value and most importantly future prospects. Nevertheless, a CEO's compensation package includes lucrative incentives tied to the firm's stock price. Whether a governance board completely understands the rather tenuous connection between a CEO's decisions, stock price and compensation is a matter for future investigation. Finally, an unanticipated series of findings emerged from this 2015 follow-up research.

The governance boards of the 33 public traded firms located in the state of Wisconsin gave on average a 6 percent pay increase to their CEOs between 2010 and 2014. Interestingly the average Wisconsin worker also received an average pay increase of 6 percent during the same time. While the annual increases appear to be equitable, the pay disparity between Wisconsin CEOs to the average employee in 2014 was 103:1 a 3 percent increase compared to the 99:1 ratio in 2010; however still significantly lower than national averages. Nonetheless, a 99:1 pay differential may not provide much solace to those who struggle to meet their bills on a weekly basis. One reason for the decline in real wages may be the historical percentage weakening of wage and salary workers represented by unions. In 2014 in the state of Wisconsin, unions (U.S. Bureau of Labor Statistics, 2015) represented 11.3 percent. The continuous decline of manufacturing industries and union membership in the state of Wisconsin and its possible moderating influence on CEO pay and overall wage disparity is a subject for further research.

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