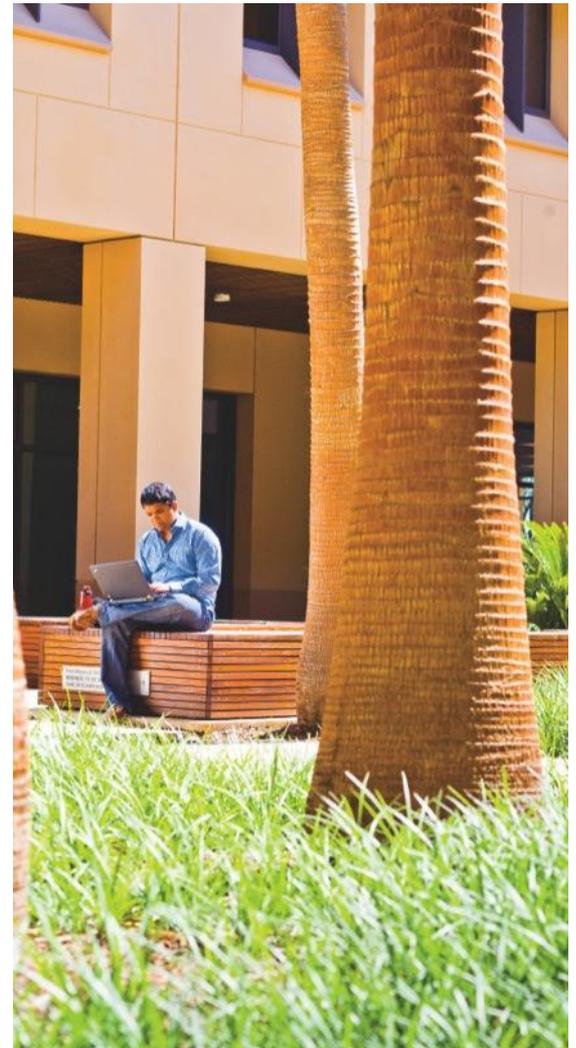


# Executive Compensation and Incentives

Professor David F. Larcker  
Center for Leadership Development & Research  
Stanford Graduate School of Business



*Change lives. Change organizations. Change the world.*

**STANFORD** GRADUATE  
**BUSINESS** SCHOOL OF

Center for Leadership  
Development and Research

# Executive Compensation

The compensation program serves three main purposes.

1. It must **attract** executives with the skills, experiences, and behavioral profile necessary to succeed in the position.
2. It must be sufficient to **retain** these individuals, so they do not leave for alternative employment.
3. It must **motivate** them to perform in a manner consistent with the strategy and risk-profile of the organization and discourage self-interested behavior.

# Elements of Compensation

The compensation package includes some or all of the following:

- **Annual salary.** Fixed cash payment made evenly over the year. The IRS limits the tax deductibility of compensation greater than \$1 million, unless it is performance driven.
- **Annual bonus.** Additional payment (usually cash) awarded if performance exceeds predetermined targets. Generally expressed as a percentage of salary and includes a guaranteed minimum and a specified maximum. Targets are based on quantitative and/or qualitative factors.

# Elements of Compensation

- **Stock options.** Right to buy shares in the future at a fixed exercise price, generally equal to stock price on the grant date. Typically vest evenly (e.g., annually over four years) and expire at the end of the term (generally ten years). Variations include:
    - **Premium options.** Exercise price higher than current price.
    - **Performance-vested (accounting-based).** Accelerated vesting based on achieving accounting-based targets.
    - **Performance-vested (stock-price based).** Accelerated vesting based on total stock price returns.
    - **Performance-vested (nonfinancial-based).** Accelerated vesting based on strategic milestone (e.g., FDA approval).
- Only 5 percent of top 250 U.S. firms have performance-based vesting.

Frederic W. Cook (2009)

# Elements of Compensation

- **Restricted stock.** Outright grant of shares that are restricted in transferability and are subject to vesting. Once vested, they are economically equivalent to outright ownership of stock.
- **Performance units (shares).** Cash (or stock) granted if specified targets are met over a three- to five-year period. Size of the award is generally expressed as a percentage of base salary. Performance units are similar to a longer-term version of the annual bonus.
- **Perquisites.** Other amenities purchased or provided by the company (such as personal use of company airplane).

# Elements of Compensation

- Contractual agreements. Other cash or stock payments stipulated in the employment agreement, such as severance, post-retirement consulting, and change-in-control payments (“golden parachutes”).
- Benefits. Other benefits such as health insurance, post-retirement health insurance, 401(k), supplemental executive retirement plans (SERPs), life insurance, payment for use of financial planner, and certain tax reimbursements.

- Do compensation programs need to be this complicated?

# Restrictions on Compensation

Compensation programs might also be subject to restrictions:

- **Stock ownership guidelines.** Executive is required to own a minimum amount of company stock, generally expressed as a multiple of base salary (five times).
- **Clawbacks.** Company provides that it can reclaim compensation in the future if it determines that the compensation should not have been awarded. Clawback policies are now required under the Dodd-Frank Act.

- In 2006, only 10% of Fortune 100 had disclosed a clawback policy.
- In 2010, this figure increased to 82%.

Equilar (2010)

# Designing the Compensation Program

- The compensation committee recommends compensation of the CEO and other executive officers.
- Packages are approved by independent directors of the full board. Shareholders approve equity-based compensation.
- Details are disclosed in the annual proxy:

Compensation philosophy	Pay equity, CEO vs. other execs
Elements of compensation	Pay equity, CEO vs. avg. employee
Total compensation awarded	Stock ownership guidelines
Total compensation realized	Clawback policies
Peer group, compensation design	Severance agreements
Peer group, measuring performance	Golden parachutes
Criteria for awarding variable pay	Post-retirement compensation

# Determining the Level of Compensation

- Most boards benchmark CEO pay against a peer group of companies comparable in size, industry, and/or geography.
  - Common practice targets cash compensation (salary + bonus) at 50th percentile and long-term pay at the 75th percentile.
  - There are potential drawbacks to benchmarking:
    - Might lead to ratcheting.
    - Is based on size rather than value creation.
    - Is highly dependent on companies included in peer group.
- Companies include unrelated firms in peer group.
  - The inclusion of these firms increases pay.

Faulkender and Yang (2010)

# Compensation Consultants

- Most companies use a third-party consultant to advise on compensation levels and program design.
  - Compensation consultants *might* be subject to conflicts of interest if they provide other services to the company, such as benefits consulting or pension asset management.
- CEO pay is higher among companies that use a consultant, but evidence suggests this is due to governance quality, not the use of the consultant.
  - No evidence that conflicts influence pay levels. Pay levels do not vary between companies that use dedicated compensation consultants and those that use general HR consultants.

Canyon, Peck, and Sadler (2009); Armstrong, Ittner, and Larcker (2012)

# Compensation Levels

## Compensation Paid to CEOs in the U.S.

		Total Expected	Market Value
		Comp (\$)	(\$ thousands)
Top 100	Mean	\$13,527,125	\$60,397,000
	Median	11,357,478	36,577,000
101 to 500	Mean	8,862,514	8,723,000
	Median	6,546,988	6,928,000
501 to 1,000	Mean	5,623,823	2,192,000
	Median	4,100,877	2,057,000
1,001 to 2,000	Mean	2,980,475	708,000
	Median	2,129,101	639,000
2,001 to 3,000	Mean	1,768,872	186,000
	Median	1,152,533	175,000
3,001 to 4,000	Mean	932,494	39,000
	Median	613,596	35,000
1 to 4,000	Mean	3,347,868	2,889,000
	Median	1,588,389	332,000

Based on Equilar compensation data, fiscal years ending June 2008 to May 2009

# Observations on Compensation Levels

- Median compensation is considerably lower than mean compensation. Outliers influence mean results.
- Compensation reflects **expected** value awarded during the year. It does not reflect value of compensation **realized**.
- Press often cites realized pay. This is *highly* misleading, in that it reflects pay granted over multiple years but realized in one.
- Company size is a major determinant of compensation levels.

- 1980-2003 change in pay is explained almost entirely by change in company size.
- Increase in executive compensation is largely consistent with pay increases for hedge funds, private equity, VCs, lawyers, and athletes.
- **But** weak governance is correlated with excessive pay levels (above average pay, given company size and performance).

Gabaix and Landier (2008); Kaplan and Rauh (2010); Core, Holthausen, and Larcker (1999)

# Pay Inequity: Executive Officers

There is a large pay differential between the pay granted to the CEO and the pay granted to other senior executives.

On average, the CEO earns 1.8 times the pay of the 2nd highest officer. The 2nd highest earns 1.2 times the 3rd.

- (+) Might reflect relative value creation of these jobs.
- (+) Pay inequity provides incentive for promotion.
- (-) Might reflect management entrenchment.
- (-) Discourages executives who feel they are not paid fairly.
- (-) Might reflect lack of internal talent development.

- Some companies limit CEO pay relative to other executives.

# Pay Inequity: Average Employee

- The press often cites the ratio of CEO pay to that of the average employee as a sign of excessive compensation.
- This figure varies greatly with methodology. It has been calculated as either 180, 300, 400, or 500 in recent years.
- It also varies with industry, size, location, and measurement period.
- It is difficult to interpret. Does it reflect relative value creation, scope of job, or expendability of the position?

- Compensation is best evaluated in terms of suitability for the job. Still, boards should be mindful of public perception.

# Compensation Mix

- In addition to determining compensation levels, the board decides how to structure compensation.
- The mix of compensation should be appropriate to attract, retain, and motivate executives in the short and long terms.

	Salary	Bonus	Stock Options	Restricted Shares	Perf. Plans	Other
Top 100	9.2%	17.9%	32.1%	18.3%	19.3%	3.1%
101 to 500	10.8%	18.1%	32.0%	19.7%	15.8%	3.7%
501 to 1,000	13.8%	18.6%	28.1%	23.9%	12.4%	3.2%
1,001 to 2,000	20.6%	15.8%	25.4%	23.6%	9.1%	5.5%
2,001 to 3,000	26.0%	13.2%	23.6%	20.5%	8.1%	8.6%
3,001 to 4,000	40.4%	12.7%	21.6%	15.5%	4.1%	5.7%
1 to 4,000	17.5%	16.6%	27.9%	21.1%	12.1%	4.7%

Based on Equilar compensation data, fiscal years ending June 2008 to May 2009

# Short-Term Incentives

- Short-term incentives offer an annual payment (usually cash) for achieving predetermined performance objectives.
- The size of the bonus is expressed in terms of a target, with a minimum and maximum level.
- The board should consider the following:
  - How difficult are the performance targets?
  - Does the plan encourage a short-term focus?
  - Does management defer investments to achieve targets?
  - Are earnings deferred after maximum targets are met?
  - Are earnings manipulated to increase payouts?

# Long-Term Incentives

Long-term incentives are added to the mix to encourage the selection of long-term investments that increase value.

Many companies use stock options to achieve this focus.

- (+) Increase in value with stock price.
- (+) Encourage investment in “risky” positive NPV projects.
- (+) Vesting allows for deferred realization of value.
- (-) Rewards can be capricious in a volatile market.
- (-) Might encourage excessive risk-seeking to increase value.

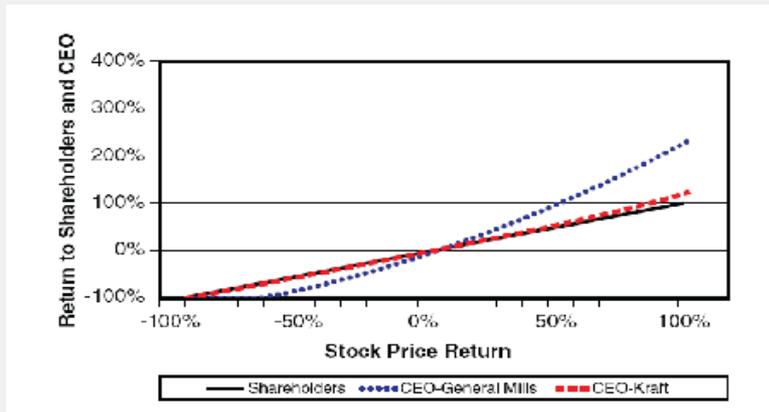
- Options encourage investment in higher-risk/reward projects.
- Executives are more likely to invest in R&D, Cap Ex, and acquisitions. Total shareholder returns are more extreme (positive and negative).

Rajgopal and Shevlin (2002); Sanders and Hambrick (2007)

# Pay for Performance

- Is there pay for performance in CEO compensation contracts? There is no single methodology for answering this question.
- The board might consider the relationship between the total wealth awarded to the CEO (salary, stock options, direct stock ownership, and other incentives) over changes in stock price.

Relationship Between CEO Wealth and Stock Price



What is the upside?

What is the downside?

What reward is promised?

What risk is encouraged?

Are these appropriate?

# Efforts to Reform Compensation

- More proxy disclosure:
  - Disclosure might be too long and confusing already.
- Say on pay:
  - Little evidence that advisory vote reduces pay levels.
- Strict limits:
  - Potential to drive talent from public to private companies.
- Require longer retention periods for equity:
  - Might encourage risk aversion.
- A better approach is to continue to improve governance quality/transparency and discourage self-interested behavior.

A better approach is to continue to improve governance quality/transparency and discourage self-interested behavior.

# Bibliography

Frederic W. Cook & Co. The 2009 Top 250—Long-Term Incentive Grant Practices for Executives. 2009. Available at: [http://www.fwcook.com/alert\\_letters/2009\\_Top-250-Report.pdf](http://www.fwcook.com/alert_letters/2009_Top-250-Report.pdf).

Equilar. Clawback Policy Report: An Analysis of Compensation Recovery Policies at Fortune 100 Companies. 2010.

Michael Faulkender and Jun Yang. Inside the Black Box: The Role and Composition of Compensation Peer Groups. 2010. *Journal of Financial Economics*.

Martin J. Conyon, Simon I. Peck, and Graham V. Sadler. Compensation Consultants and Executive Pay: Evidence from the United States and United Kingdom. 2009. *Academy of Management Perspectives*.

Chris S. Armstrong, Christopher D. Ittner, and David F. Larcker. Corporate Governance, Compensation Consultants, and CEO Pay Levels. 2012. *Review of Accounting Studies*.

Xavier Gabaix and Augustin Landier. Why Has CEO Pay Increased So Much? 2008. *Quarterly Journal of Economics*.

Steven N. Kaplan and Joshua Rauh. Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes? 2010. *Review of Financial Studies*.

John E. Core, Robert W. Holthausen, and David F. Larcker. Corporate Governance, Chief Executive Officer Compensation, and Firm Performance. 1999. *Journal of Financial Economics*.

Shivaram Rajgopal and Terry Shevlin. Empirical Evidence on the Relationship Between Stock Option Compensation and Risk Taking. 2002. *Journal of Accounting & Economics*.

W. M. Sanders and Donald C. Hambrick. Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance. 2007. *Academy of Management Journal*.