Seven Myths of Executive Compensation

By David F. Larcker and Brian Tayan
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INTRODUCTION

Executive compensation is perhaps the most contentious issue in corporate governance today. Common consensus holds that CEOs of publicly traded U.S. corporations, particularly the largest U.S. corporations, are overpaid. It is also widely believed that the structure of CEO pay is inappropriate, that rewards are offered without regard to performance, and that compensation design encourages excessive risk-seeking behavior that is costly to shareholders.[1] To cure these, activists have stepped up efforts to rein in pay, and Congress passed the Dodd-Frank Act of 2010 which, among its many provisions, mandates a series of compensation reforms.[2] While it is likely true that among some companies compensation is not merited based on performance, the truth about executive compensation is more nuanced than common consensus suggests. Public debate would benefit from the clarification of several commonly held misconceptions.

MYTH #1: THE RATIO OF CEO-TO-AVERAGE-WORKER PAY IS AN INFORMATIVE STATISTIC

Those who allege that executives in the United States are overpaid point to the large differential between the compensation awarded to the CEO and that of the average employee. Recent estimates put this ratio anywhere between 180 and 500, depending on methodology and the sample employed. Dodd-Frank now requires that companies calculate and disclose this ratio in the annual proxy. Proponents of this approach believe that companies with a high ratio will face shareholder pressure to decrease CEO pay.

However, the ratio of CEO-to-average worker pay is a metric that suffers from several shortcomings. First, it is difficult to compare across companies. The ratio is influenced by a company's industry, size, location, and structure of the workforce. For example, a company that retains low-wage employees on a full time basis will have a higher ratio than one that relies on temporary or outsourcing contracts. As a result, companies might appear to have grossly different pay practices when in fact their ratios are skewed by situational factors relating to their strategy or environment. Furthermore, the statistic is difficult to interpret. Is the ratio supposed to measure the relative value creation between the work of the CEO and that of the average employee (i.e., does the CEO create 200 times more shareholder value than the average employee)? Or does it measure relative responsibility (i.e., does oversight responsibility for a $20 billion company merit 200 times more in compensation than the oversight responsibility of the average worker in that company)? Or does it measure relative expendability of the positions (i.e., would the company choose to eliminate the CEO position or 200 other positions selected at random)? Although pay inequity is an important social consideration, it is dangerous to collapse a complicated issue into a single ratio.

MYTH #2: COMPENSATION CONSULTANTS CAUSE PAY TO BE TOO HIGH

Another area of popular concern is the use of third-party consultants to assist in the process of setting compensation. Critics claim that compensation consultants recommend overly generous pay contracts because they are beholden to the managers who hire them. They also allege that a conflict arises when a company uses the same consulting firm to structure CEO compensation and perform other corporate services, such as designing benefits plans or managing pension assets. In such a situation, the consulting firm might recommend generous pay for fear of losing the other service contracts.

Although potential conflicts of interest should always be a concern to investors, this myth is not supported by the research literature. The research shows that excessive pay levels tend to result from governance shortcomings in firms and not whether firms use a compensation consultant or whether the compensation consultant is potentially conflicted. Pay levels tend to be too high (relative to size, industry, performance, etc.) when board members are personal friends of the CEO, appointed by the CEO, highly busy in terms of total board appointments, and when other systemic flaws are present. Once these variables are controlled for, the correlation between use of a consultant and pay levels disappears.[3]

MYTH #3: IT IS EASY TO TELL WHETHER PAY CAUSES "EXCESSIVE" RISK TAKING

Many accept the claim that excessive risk taking caused the financial crisis and that the structure of executive compensation contracts (particularly those awarded by financial institutions) encouraged excessive risk taking. As a result, the Dodd-Frank Act now requires companies to disclose the relation between the executive compensation contract and organizational risk.

Unfortunately, we do not know the relation between compensation and excessive risk taking. First, "excessive risk" is not a well-defined term. CEOs are responsible for making decisions about corporate strategy and this, in part, requires the pursuit of investments that are "risky," in that their future payout is unknown in advance. However, there is no bright-line rule that distinguishes "excessive" versus "acceptable" risk.[4] Second, researchers do not have the tools to examine a compensation plan and determine which elements encourage excessive risk and which do not. Many blame equity incentives (stock options, restricted shares, and performance plans), but this is naïve because equity incentives are an important tool to motivate positive behavior among executives. They extend the time horizon of the executive and increase in value only if he or she is able to increase shareholder value. A lot more careful research will be necessary before we have a clear understanding of how the structure of a compensation package correlates with excessive risk taking.

One potentially serious and unintended consequence of Dodd-Frank is that companies might respond to the new disclosure laws by eliminating appropriate incentives (such as stock options) or capping the maximum bonus at a relatively low level regardless of performance in order to decrease the appearance of risk. To the extent that these actions remove important incentives, shareholders could suffer through less innovation and lower investment returns (see Exhibit 1).

MYTH #4: PERFORMANCE METRICS AND TARGETS TIE DIRECTLY TO CORPORATE STRATEGY

Annual bonus plans tend to be complicated. In many cases, the target value depends on the achievement of several financial and nonfinancial targets, each of which carries an individual weighting. Many shareholders assume that these targets map directly to the corporate strategy and that the company has verified through rigorous statistical analysis that performance measures correlate with the desired corporate outcomes. However, the research evidence contradicts this assumption. Many companies simply do not do a good job of making this connection in a rigorous way.[5] For one thing, it is difficult to develop a causal business model that links specific metrics in a logical chain to delineate how performance metrics translate into shareholder value. Instead, many companies rely on performance metrics that are easily observable and ones that are widely used or have been used in the past. They also tend to overemphasize financial metrics at the expense of important nonfinancial metrics, such as customer satisfaction, product innovation, and employee turnover. As a result, in many companies there is a gap between the measures they should use to determine performance and the measures they actually use (see Exhibit 2).

MYTH #5: DISCRETIONARY BONUSES SHOULD BE ELIMINATED

In some cases, the board of directors might choose to grant a bonus to the CEO, even though the company has missed its predetermined performance targets. Such bonuses are called discretionary. Some shareholder activists believe that discretionary bonuses should not be awarded, because they reflect pay that is unmerited (so-called "pay without performance"). However, there are times when external factors outside an executive's control—such as an unexpected change in economic conditions or competitive dynamics—hurt the company performance. The board needs to assess whether operating results would have met or exceeded expectations had these events not occurred. If so, it might make sense to reward management despite missing predetermined objectives. In doing so, the board should clearly explain the basis of its decision to shareholders. (Companies are now required to highlight discretionary bonuses in SEC filings.)

MYTH #6: PROXY ADVISORY FIRMS KNOW HOW TO EVALUATE COMPENSATION CONTRACTS

Dodd-Frank requires that companies grant shareholders a nonbinding, advisory vote on the executive compensation plan. Such votes must occur every one, two, or three years (at the determination of shareholders). This practice is known as "say on pay" and has been adopted in various forms by countries outside the U.S.

Proxy advisory firms are heavily influential in the say-on-pay process. By some estimates, an unfavorable recommendation on management-sponsored compensation proposals can reduce shareholder support by 20 percent.[6] All 31 companies that have failed to receive majority support for their say-on-pay vote so far in 2011 received a negative recommendation from Institutional Shareholder Services, the largest advisory firm.[7]

While there is clearly a place in the market for third-party firms to advise on proxy-related issues (particularly complicated ones such as compensation), it is not clear that the models currently used by these firms enhance shareholder value. They tend to emphasize relative one- and three-year total shareholder return and change in CEO pay, without taking into account specific industry, company, or strategic factors.[8] They also automatically recommend against a compensation plan if certain features are in place, such as if the company allows stock option repricing without shareholder approval, "excessive" perquisites, tax gross-ups on benefits, and new or extended employment agreements. While governance experts might disapprove of these pay practices, to our knowledge there is no rigorous research evidence that the methodology employed by proxy advisory firms is predictive of future performance or that it is accurate in distinguishing between "good" and "bad" pay practices (see Exhibit 3).

MYTH #7: CURRENT MODELS ACCURATELY REFLECT THE VALUE OF CEO OPTIONS

Companies include stock options in the compensation plan to provide incentive to create long-term value. Research evidence suggests that options are effective in this regard: executives understand that the expected value of a stock option increases with the volatility of the stock price, and they tend to respond to stock option awards by investing in riskier projects to create this volatility.[9]

Although companies are required to report the value of stock option grants in their financial statements and the annual proxy, the truth is that the models used to value such options (Black-Scholes and the binomial pricing model) do not take into account important human behavior that might influence their value. For example, an uninterested third-party who purchases or sells an option in the secondary market has no ability to affect that option's value in the future. He or she is simply making a financial investment whose future value is outside of their personal control. By contrast, in the case of an executive stock option, the board of directors is providing a financial incentive because it explicitly wants the executive to take actions to increase the stock price. The models used in financial statements do not take this factor into account. They also do not take into account other known behavioral attributes, such as the fact that executives might be risk averse and exercise their options early (due to unwillingness to bear risk when the option is "in the money"). Although these factors are difficult to quantify, boards of directors would benefit from more precise valuation models that more closely measure the cost of stock options to the firm and their value to the executive.

WHY THIS MATTERS

1. The size and structure of executive compensation contracts clearly affect the ability of companies to attract, retain, and motivate qualified executives who will create value on behalf of shareholders and stakeholders. Artificial changes to satisfy the unsupported claims of experts without a careful consideration of the impact on executive behavior will almost certainly do more harm than good.
2. The problem of inappropriate compensation (when it occurs) likely will not be remedied by governmental reform and congressional legislation. A better solution is to use the research on executive compensation and corporate governance to provide a fact-based solution. ■

[1] For a discussion of CEO pay levels and pay for performance, see: David F. Larcker and Brian Tayan, "Seven Myths of Corporate Governance," CGRP-16 (Jun. 1, 2011). Available at: http://www.gsb.stanford.edu/cldr/research/closer_look.html.

[2] Compensation-related provisions of Dodd-Frank include the requirements that companies grant shareholders an advisory vote on executive compensation ("say on pay"), adopt clawback policies, disclose the ratio of total CEO compensation to that of the average worker, explain the relation between executive compensation and risk, and disclose whether executives are allowed to hedge their equity securities.

[3] See: Kevin J. Murphy and Tatiana Sandino, "Executive Pay and 'Independent' Compensation Consultants," *Journal of Accounting & Economics* (2010); and Chris S. Armstrong, Christopher D. Ittner, and David F. Larcker, "Corporate Governance, Compensation Consultants, and CEO Pay Levels," *Review of Accounting Studies* (forthcoming).

[4] One possible definition for excessive risk taking would be investments characterized by large volatility and negative net present value (i.e., investments that are "speculative").

[5] See Deloitte Touche Tohmatsu, "In the Dark: What Boards and Executives Don't Know about the Health of Their Businesses." (2004); "In the Dark II: What Many Boards and Executives Still Don't Know About the Health of Their Businesses." (2007); and Christopher D. Ittner and David F. Larcker, "Coming Up Short on Nonfinancial Performance Measurement," *Harvard Business Review* (Nov. 2003).

[6] Angela Morgan, Annette Poulsen, and Jack Wolf, "The Evolution of Shareholder Voting for Executive Compensation Schemes," *Journal of Corporate Finance* (2006).

[7] Companies include Hewlett-Packard, Jacobs Engineering, Stanley Black & Decker, and Masco Corp. Source: Semler Brossy, "2011 Say on Pay Results: Russell 3000," (Jun. 9, 2011). Available at: http://www.semlerbrossy.com/pages/pdf/SOP_Update.pdf.

[8] For example, it might not make sense to use one- and three-year total shareholder return to evaluate the performance of companies that have considerably longer investment horizons, such as oil production companies and biotechnology.

[9] Shivaram Rajgopal and Terry Shevlin, "Empirical Evidence on the Relationship Between Stock Option Compensation and Risk Taking," *Journal of Accounting & Economics* (2002); and W. M. Sanders and Donald C. Hambrick, "Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance," *Academy of Management Journal* (2007).

David Larcker is the Morgan Stanley Director of the Center for Leadership Development and Research at the Stanford Graduate School of Business and senior faculty member at the Rock Center for Corporate Governance at Stanford University. Brian Tayan is a researcher with Stanford's Center for Leadership Development and Research. They are coauthors of the books *A Real Look at Real World Corporate Governance* and *Corporate Governance Matters.*
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EXHIBIT 1 — DISCLOSURE: RELATION BETWEEN COMPENSATION AND "EXCESSIVE" RISK TAKING

MOOG

In light of the current global economic and financial situation, the Committee has considered how recent events might affect the Company's Executive Compensation program. After review, a determination was made that no modifications to the compensation programs need to be made at this time. There are no risks associated with the Company's incentive compensation programs which could threaten the value of the Company or its shareholders.

LILLY

The committee noted several design features of the company's cash and equity incentive programs for all employees that reduce the likelihood of excessive risk-taking:

- The program design provides a balanced mix of cash and equity, annual and longer-term incentives, and performance metrics (revenue, earnings, and total shareholder return).
- Maximum payout levels for bonuses and performance awards are capped at 200 percent of target.
- All regular U.S. employees participate in the same bonus plan.
- Bonus and equity programs have minimum payout levels for nonexecutive officers.
- The company currently does not grant stock options.
- The compensation committee has downward discretion over incentive program payouts.
- The executive compensation recovery policy allows the company to "claw back" payments made using materially inaccurate financial results.
- Executive officers are subject to share ownership and retention guidelines.
- Compliance and ethical behaviors are integral factors considered in all performance assessments.

AMERIPRISE FINANCIAL

There are no objective tests to determine whether one type of incentive compensation plan encourages executive officers to take excessive and unnecessary risks while another type of plan encourages only prudent and appropriate risk taking. Nevertheless, we will continue to examine our incentive compensation plans during 2010 to identify any plan features that may be incompatible with our enterprise risk-management program. With that said, it is not always easy to categorize risks as excessive or appropriate, except with the benefit of hindsight. [T]he question we have been asking ourselves is this: 'Are the Company's enterprise risk-management framework and internal controls effective to prevent or to identify and mitigate risk taking by our executive officers that exceeds our risk tolerances, regardless of the incentive compensation plan in which he or she participates?' We believe that the answer to that question is 'Yes.' Nevertheless, we will continue to give additional attention to the subject of risk and compensation as we continue to enhance our enterprise risk-management program.

Sources: Moog, Form DEF-14A, filed with the SEC Dec. 10, 2008; Lilly, Form DEF-14A, filed with the SEC Mar. 8, 2010; and Ameriprise Financial, Form DEF-14A, filed with the SEC Mar. 19, 2010

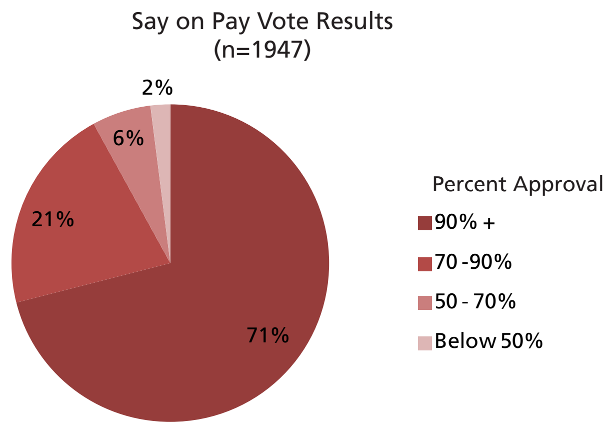
EXHIBIT 2 — MEASURES TO DETERMINE CORPORATE PERFORMANCE

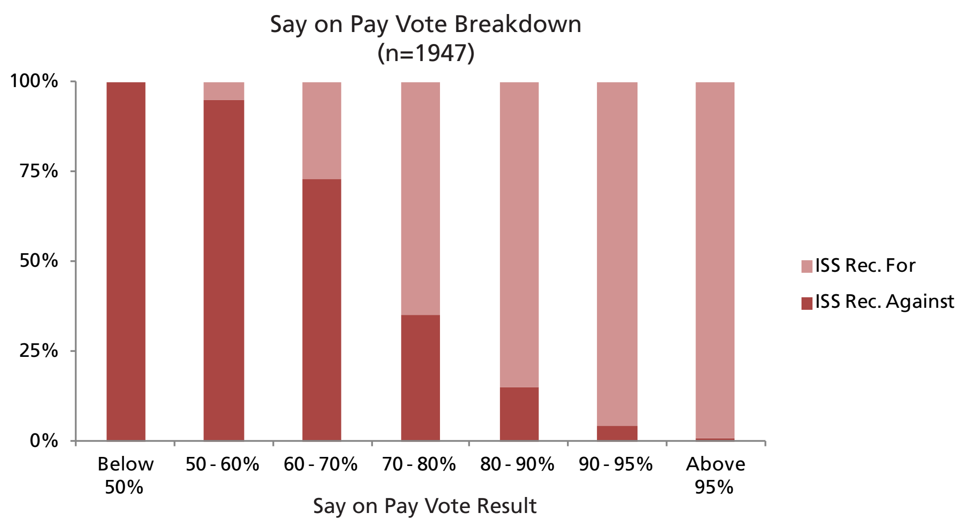
Measures Used for Corporate Employees	Overall Prevalence
Profit Measures	**77%**
Earnings Per Share	29%
EBIT/EBITDA	19%
Net Income	16%
Operating Income	15%
Pretax Profit	7%
Return Measures	**14%**
Return on Capital	6%
Return on Assets	3%
Return on Equity	3%
Return on Investment	2%
Return on Net Assets	2%
EVA/Cash Flow Measures	**26%**
Cash Flow	16%
Economic Value Added (EVA)/Economic Profit	8%
Working Capital	3%
Cash Value Added (CVA)	1%
Other Measures	**62%**
Individual Objectives	23%
Sales/Revenue/Revenue Growth	20%
Customer Satisfaction	8%
Service/Quality	6%
Strategic Goals/Projects	6%
Discretionary	4%
Expense Reduction	3%
Safety	3%
Employee Satisfaction	2%
Total Shareholder Return	1%
Other Various/Combinations of Measures	28%

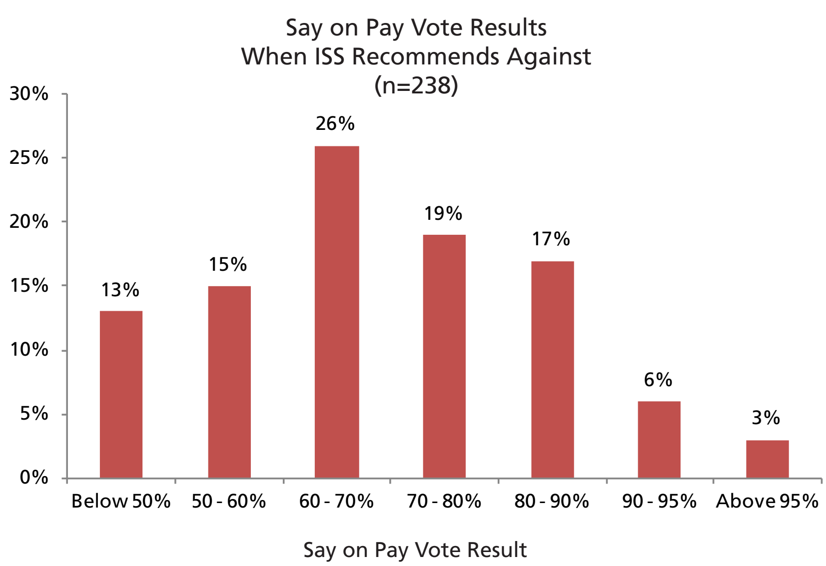
Note: Some of the other measures used include inventory turnover, operating expenses, and process/product improvement.

Source: Confidential survey (2005). Sample includes 343 industrial and service companies.

EXHIBIT 3 — SAY ON PAY: VOTING RESULTS (2011)







Source: Semler Brossy. 2011 Say on Pay Results: Russell 3000 (Jun. 9, 2011).