CEO PAY, PERFORMANCE, AND VALUE SHARING

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INTRODUCTION

CEO compensation is a controversial subject that evokes considerable debate on whether public company CEOs are paid correctly both in level and relative to corporate performance. Recent surveys by the Rock Center for Corporate Governance at Stanford University and Heidrick & Struggles highlight the extreme disconnect between public perception of CEO pay and the perception of directors responsible for designing pay packages at Fortune 500 companies. While 65 percent of directors believe that CEO pay is not a problem, a full 70 percent of the American public believe that it is.[1]

In terms of recourse, members of the public and corporate directors are also divided. Sixty-two percent of the public believe that CEO pay should be capped relative to that of the average worker, and 49 percent favor some type of government intervention to change current practices. Potential remedies favored by these respondents include substantial tax increases, strict limits on absolute and relative pay levels, a required increase in performance-based compensation, and elimination of stock options and equity-based awards. By contrast, corporate directors strongly oppose external intervention. Eighty-four percent believe that there should be no limit to CEO pay relative to that of the average worker, and almost all (98 percent) oppose government intervention in all forms (see Exhibit 1).

These results demonstrate the public relations challenge that corporate directors face explaining and justifying CEO pay arrangements, including how compensation ties to corporate performance and shareholder-value creation.

PAY FOR PERFORMANCE AND VALUE SHARING

CEO compensation packages represent an economic sharing arrangement between a company and an executive. In principle, the level and structure of compensation offered to an executive should reflect the pay necessary to attract, retain, and motivate him or her to create value for a company—taking into account the supply and demand of a competitive labor market and the pay opportunities available at alternative employers. A simple value sharing equation might be as follows (see Exhibit 2):

1. *How much value is expected to be created over a designated period?*
2. *How much does the executive team and CEO personally contribute to value creation?*
3. *What portion of this contribution should be given to the CEO as compensation?*

The difficulty that boards face in justifying CEO pay levels in some ways stems from the challenge of quantifying the answers to these three important questions.

First, there is no clear cut method for measuring value creation. To the extent that stock prices accurately and efficiently reflect changes in corporate value, total shareholder return might be the most accurate measure of value creation in a given period; however, to the extent that the prices of individual securities are influenced by exogenous broad-market trends or behavioral sentiment, total shareholder return might be inadequate. Similarly, profitability metrics (such as operating income, free cash flow, or earnings per share) are influenced by possibly uncontrollable macroeconomic and cyclicality factors. Moreover, it is not completely clear how to convert these operating metrics into shareholder value (i.e., they must be capitalized at appropriate interest rates to arrive at an estimate of value creation).

Survey data demonstrates the disagreement that board members and chief executive officers have over the most appropriate method of measuring value creation. While directors are more likely to believe that total shareholder return is the best measure of company performance, CEOs are more likely to believe that profitability measures (operating income and free cash flow) are best. This is perhaps not too surprising since CEOs are more likely to have a direct influence on operating performance than stock prices. Still, no single measure receives consensus support, and most companies do not measure corporate performance with a single metric (see Exhibit 3).

It is also extremely difficult to quantify the contribution that an executive team, much less an individual executive, makes to overall organizational performance. Researchers have tried to estimate the value a CEO contributes with highly mixed results. For example, Thomas (1988) finds that CEOs are responsible for only 3.9 percent of the variance in performance among companies, while Mackey (2005) finds that the impact is as high as 29.2 percent.[2] These considerations are further complicated by important differences among companies. At companies in industries with long product development cycles or long product life cycles—such as pharmaceuticals and technology licensing—CEOs are unlikely to have a substantial impact on current year or near-term revenues. The quality of the research and investment choices of those CEOs may not be known for a decade or longer. In other industries the CEO can have a profound immediate effect.

Directors have a more favorable view than even the highest estimate above. According to survey data, directors believe that 40 percent of a company's overall performance is directly attributable to the efforts of the CEO.

Finally, no formal standard exists for sharing value between a CEO and shareholders. Interviews with compensation consultants suggest that shareholders are satisfied if the CEO receives 1 percent of total shareholder return over a three-year period.[3] For example, if $4 billion in value is generated through an increase in market capitalization and dividends paid, shareholders are satisfied with a CEO earning $40 million. Survey data suggests that directors consider a similar value sharing arrangement to be fair. Given a hypothetical situation in which a company's value increases by $100 million over the course of a year, the typical director believes it is fair to pay the CEO $2 million (2 percent) in compensation. Still, these are not rigid standards for structuring pay packages. Explicit value sharing equations are not typically agreed to in advance, and most companies do not disclose this calculation retrospectively.[4]

So long as corporate stakeholders and members of the public do not agree on the key qualitative and quantitative assumptions regarding how CEO compensation should be set, the topic of CEO compensation is likely to remain controversial.

WHY THIS MATTERS

1. Compensation is an economic value sharing arrangement between employee and employer. While this calculation is explicitly made in certain job settings—such as sales, brokerage firms, hedge funds, private equity, venture capital, professional sports, and entertainment—it is rarely made in an explicit manner at the CEO level. Why not?
2. Survey data suggests that many CEOs and directors disagree on the best measures of corporate value creation, with CEOs favoring changes in profitability measures and directors favoring market-based measures such as total shareholder return. Which of these gives a more accurate picture of corporate performance? When measuring performance, how should the board of directors control for fluctuations in the market and general economy?
3. Survey data also suggests that directors believe CEOs have considerable influence over corporate outcomes, giving them credit for approximately 40 percent of organizational performance. Is this estimate accurate or overstated? Does a high estimate partially explain why current CEO pay levels are as high as they are?
4. One method for demonstrating "pay for performance" is to calculate the relation between compensation realized by a CEO over a designated period and value creation during that period. Why don't more companies make this calculation? Would the results of this analysis assuage the controversy over CEO pay or exacerbate it? ■

[1] Public perception data cited here and throughout this Closer Look from: The Rock Center for Corporate Governance at Stanford University, "Americans and CEO Pay: 2016 Public Perception Survey on CEO Compensation," (2016). Sample includes 1,202 individuals nationally representative by gender, race, age, political affiliation, household income, and state residence. Director perception data from: Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, "CEOs and Directors on Pay: 2016 Survey on CEO Compensation," (2016). Sample includes 107 CEOs and directors of Fortune 500 companies (44 CEOs and 63 directors).

[2] Alan Berkeley Thomas, "Does Leadership Make a Difference in Organizational Performance?" *Administrative Science Quarterly* (1988). Alison Mackey, "How Much Do CEOs Influence Firm Performance—Really?" *Social Science Research Network* (2005).

[3] Interview with the authors. Note that this figure represents 1 percent of total value creation, not 1 percent of the CEO's direct contribution to total value creation.

[4] The practice of demonstrating pay-for-performance by comparing realized pay to trailing measures of corporate performance has become somewhat more common, in part due to shareholder pressure and pending regulatory rules that would require this disclosure. See David F. Larcker, Brian Tayan, and Youfei Xiao, "Pro Forma Compensation: Useful Insight or Window Dressing?" Stanford Closer Look Series (July 28, 2015).

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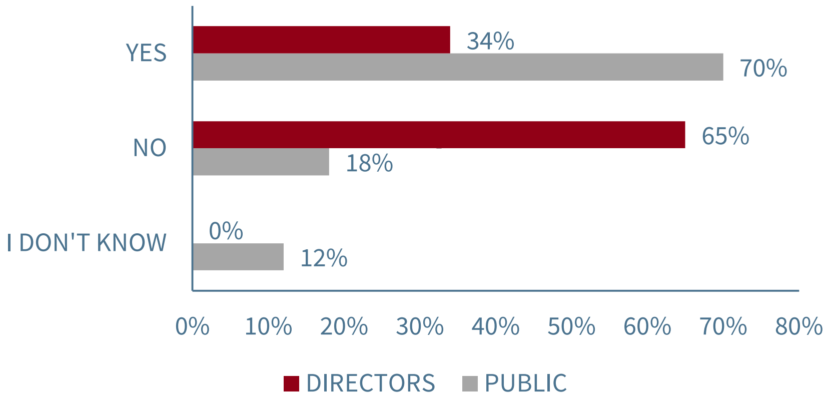
Larcker and Tayan are coauthors of the books A Real Look at Real World Corporate Governance *and* Corporate Governance Matters*. The authors would like to thank Michelle E. Gutman for research assistance in the preparation of these materials.*

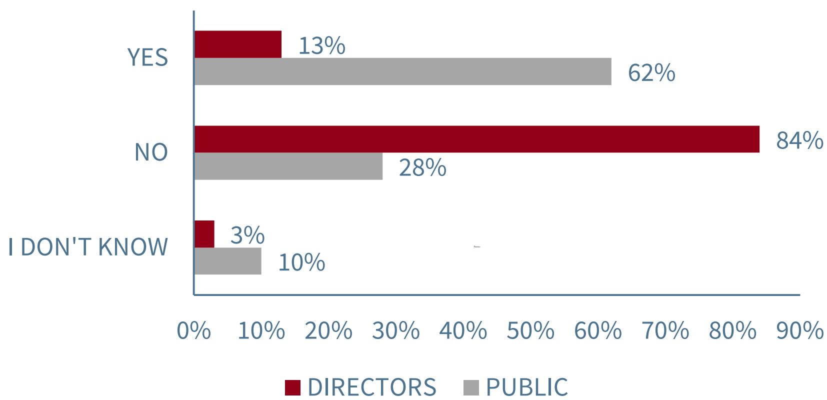
The Stanford Closer Look Series is a collection of short case studies that explore topics, issues, and controversies in corporate governance and leadership. The Closer Look Series is published by the Corporate Governance Research Initiative at the Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. For more information, visit: http:/www.gsb.stanford.edu/cgri-research.

EXHIBIT 1 — PERCEPTION OF CEO PAY: FORTUNE 500 DIRECTORS AND THE AMERICAN PUBLIC

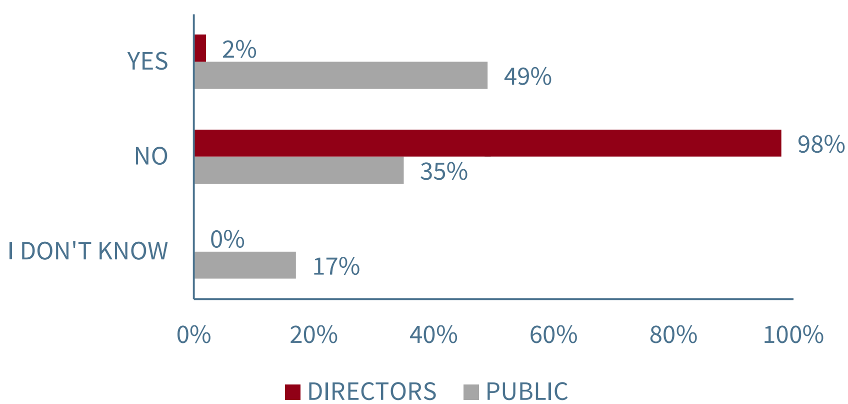
IN GENERAL, DO YOU BELIEVE THAT CEO COMPENSATION AT THE LARGEST U.S. COMPANIES IS A PROBLEM?



IN GENERAL, DO YOU BELIEVE THERE IS A MAXIMUM AMOUNT THAT A CEO SHOULD BE PAID RELATIVE TO THE AVERAGE WORKER, NO MATTER THE COMPANY AND ITS PERFORMANCE?

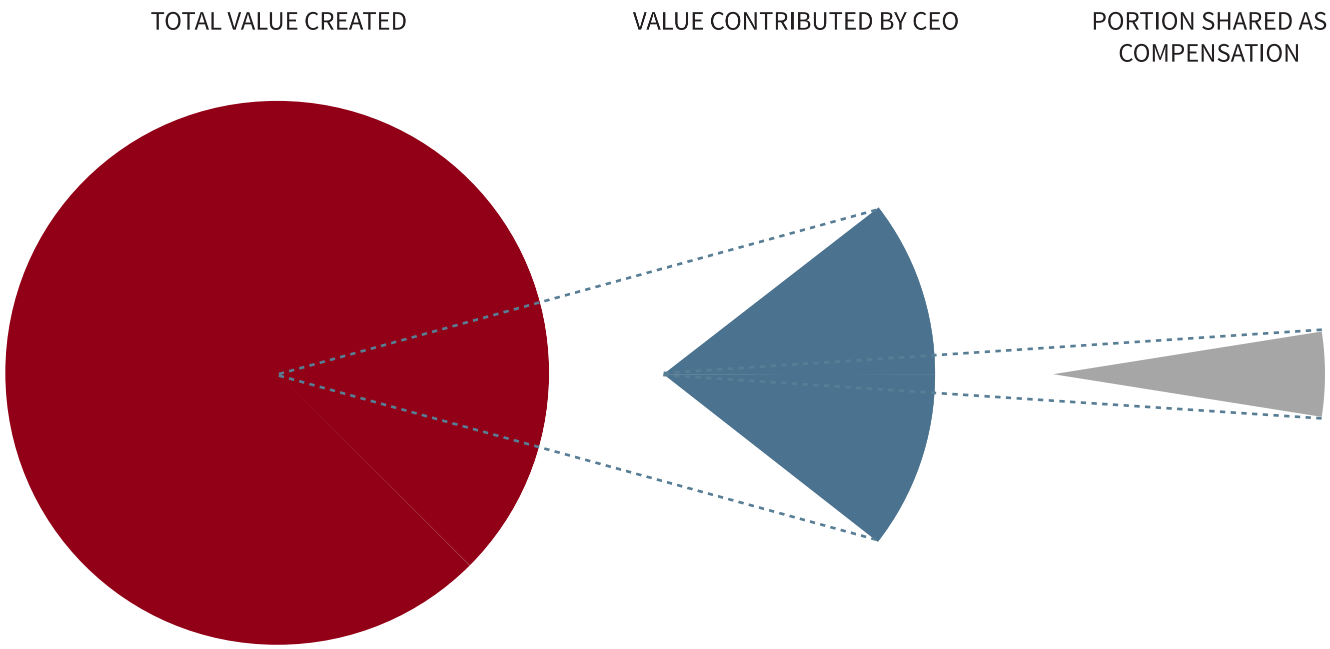


DO YOU BELIEVE THAT THE GOVERNMENT SHOULD DO SOMETHING TO CHANGE CURRENT CEO PAY PRACTICES?



Sources: The Rock Center for Corporate Governance at Stanford University, "Americans and CEO Pay: 2016 Public Perception Survey on CEO Compensation," (2016); and Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, "CEOs and Directors on Pay: 2016 Survey on CEO Compensation," (2016).

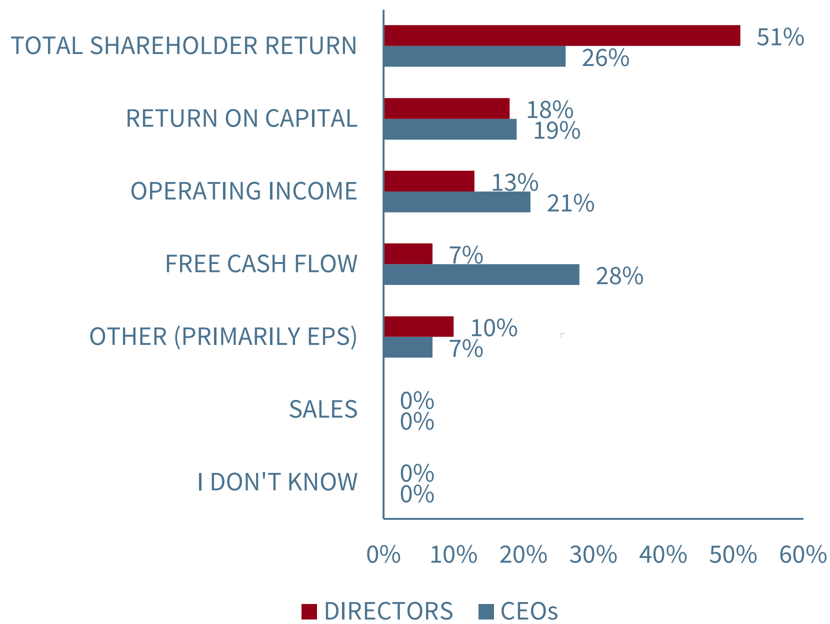
EXHIBIT 2 — GENERAL VALUE SHARING EQUATION



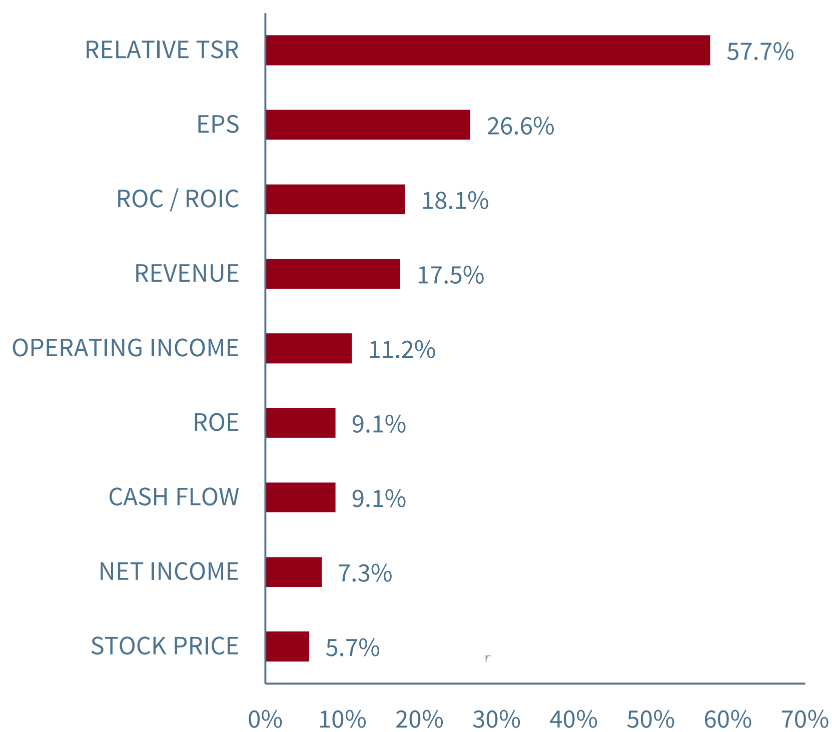
Source: The authors.

EXHIBIT 3 — CORPORATE MEASURES OF VALUE CREATION

IN YOUR OPINION, IF YOU WERE TO SELECT ONLY ONE METRIC, WHICH OF THE FOLLOWING IS THE BEST MEASURE OF COMPANY PERFORMANCE?



METRICS USED IN LONG-TERM INCENTIVE PLANS



Sources: Heidrick & Struggles and the Rock Center for Corporate Governance (2016). Equilar, "Measuring Long-Term Performance: An Analysis of S&P 500 Equity Incentive Plan Metrics," (August 3, 2014).