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CEO Pay Mix

Compensation professionals are increasingly aware of the importance of how we pay employees, not just how much.

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Of course, many employees are paid in forms of compensation beyond wages and salaries. The most recent data show wages and salaries make up just 69.1 percent of the total that employees cost their employers (U.S. Department of Labor, Employer Costs of Employee Compensation). But, one place where we see great diversity (and detail!) in compensation is that of CEOs of publicly traded firms. Because the data are public, practitioners and researchers have a wealth of information to study the optimal ways to pay executives.

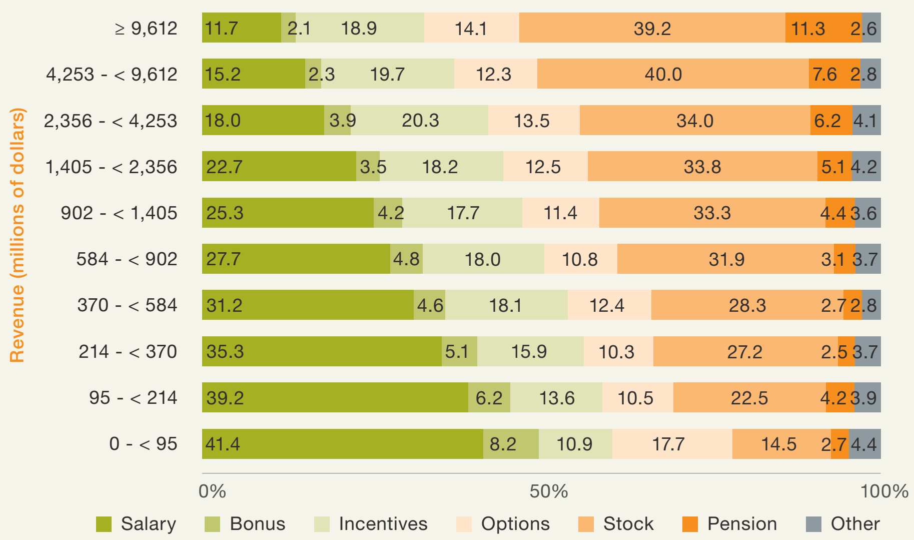
Principals, Agents and Ownership Shares

Although more disclosure and say-on-pay votes have recently increased notice of CEO pay in the public eye, issues of how to align executive pay with the interests of the business have been studied by academics and practitioners for a long time. In a famous paper from 1976, Michael Jensen and William Meckling ("Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, 3(4)) discussed several important ideas: agency theory (how employees are "agents" hired to act on behalf of the company but often working unobserved), property rights (such as who has the "right" to use a resource or take an action), the "theory of the firm" (including how the company and its employees interact in response to market, organizational and personal incentives) and what the interplay of these means for the "ownership structure of the firm." As Jensen and Meckling remind us, some of these concerns (like many big thoughts in economics) date back more than 200 years to Adam Smith's 1776 "The Wealth of Nations." Smith wrote, "The directors of such … companies, however, being the managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own" (page 439). In other words, CEOs and owners may act differently.

To align organizational ownership and managerial control, many argue that executives should be paid with some form of equity (e.g., stock, stock options). Ironically, this may have contributed to its own controversy in the public eye; namely, rapidly increasing CEO pay. As I and others have discussed elsewhere, CEO pay increased sharply after the early 1990s, around the same time as the increased issuance of equity to executives. Two classic papers to read on equity and executive compensation were written by Michael Jensen and Kevin J. Murphy more than 20 years ago ("Performance- Pay and Top Management Incentives," *Journal of Political Economy*, 98(2), 1990, and "CEO Incentives: It's Not How Much You Pay But How," *Harvard Business Review*, 1990).

Figure 1 | Average CEO Pay Mix Distribution by Size of Company (Deciles of Revenue)

U.S. publicly listed companies



Note: Figures are rounded.

Pay Mix for CEOs Today

In a previous column (February 2011), I discussed another important correlate of CEO pay levels: firm size. The size of the organization, it turns out, is also related to the CEO pay mix.

Figure 1 shows a plot of CEO compensation data taken from a report I wrote for The Conference Board (with Judit Torok), U.S. Top Executive Compensation Report 2013. In this report, we analyzed data from 2,343 publicly traded firms in the United States. To look at CEO pay mix by size of the firms, we divided the firms into 10 groups, each with roughly the equivalent number of firms. The smallest firms have annual revenue of less than \$95 million per year; the largest, annual revenues of more than \$9.6 billion. Using these size groupings, we calculate the average percent of CEO compensation that is in each of seven categories: salary, bonus, nonequity incentives, stock options, stock, change in the value of pension and "other" compensation.

Many features of this figure are fascinating. As firms increase in size, the fraction of the CEO's pay that is salary declines from 41.4 percent for the smallest firms to 11.7 percent for the largest. Note also the opposite trend for stock and options. The smallest firms have the smallest fraction of pay as equity, roughly one-third (32.2 = 17.7 + 14.5). This increases to more than half (53.3 = 14.1 + 39.2) for the largest firms. To be sure, pay mix varies for many reasons. (In The Conference Board report, we also present this chart for different industries, and there is a lot of variation.) The relationship between pay mix and firm size, however, is particularly strong.

Pay Mix: It's Not Just for CEOs Anymore

Finding solid academic research on pay mix for all employees is more difficult than for CEOs. Compensation data on most workers are not so openly disclosed as they are for the senior executives of publicly traded companies in the United States. It will be interesting to see if the move toward more disclosure extends lower into the company ranks. But for now, I expect research on pay mix, its link to performance and the changing shares of various pay components over time will continue to be more heavily focused on the top of the house, as will the public eye. ws

got a question

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