COMPENSATION CONTROVERSIES
Selected issues in rewarding CEOs

Presented by:
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The Agency Issue

• Using compensation to align the CEO’s interests with those of the ownership
Issues Explored

1. In practice, is compensation aligned with intended results?

2. Do incentives work? Are incentives delivering the desired results?

3. How do executives respond to incentives?

Limitations

• Limited time, limited scope of conversation.

• Neither an economist, nor a compensation expert.

• Assume that most the audience is focused on non-profits, but substantial amount of research focuses on for-profit sector. Caution regarding application to non-profits.
IN PRACTICE, IS COMPENSATION ALIGNED WITH INTENDED RESULTS?
Compensation Practices in Nonprofits

Do Nonprofits Use Incentive Plans?

- “Years ago it was unusual for nonprofits to have an incentive plan. Today half of all nonprofits have one, according to 2006 Clark Consulting research”
  
  *Reilly and Cumpston*

- Just 7% of nonprofit respondents reported that their organization provides a formal performance incentive plan

  *Charity Village, Canada*
What Drives Nonprofit Executive Compensation?

- Peter Frumkin and Elizabeth K. Keating
- Data from IRS Form 990 non-profit tax filings (1998 – 200)
- Hypotheses tested: CEO Compensation will
  1) Be more for large vs smaller non-profits
  2) Not be based upon organizational financial performance
  3) Not based upon “liquidity or free cash flows”
- Major non-profit subsectors:
  - Arts
  - Education
  - Health
  - Human Services and “Other”
  - Religion

Compensation for CEOs of Arts Nonprofits

- Positive relationships:
  - Program expenses * (more than any other subsector)
  - Administrative efficiency
  - Higher liquidity
  - More extensive endowment

- Negative relationship:
  - Commercial revenue share (opposite to all other subsectors)

- Not affected by:
  - Generating additional contributions
Compensation for CEOs of Nonprofit Education Institutions

- Positive relationships:
  - Fixed assets
  - Growth in contributions

- Not affected by:
  - More administratively efficient

Compensation for CEOs of Health Nonprofits

- Positive relationships:
  - Organizational size*
  - Increases in commercial revenue (highest of all subsectors)
  - Relative size of endowment
  - Administrative efficiency (weak link)

- Not affected by:
  - Growth in contributions
  - Liquidity
Supporting Research re CEOs of Hospitals

“The evidence provides strong support for the hypothesis that nonprofit hospital boards care about profit (as measured by return on assets) and corresponding incentives to CEOs. The marginal incentives for increasing profits from threat of turnover and annual salary adjustments appear as strong in nonprofit hospitals as in for-profit organizations (ignoring stock option and ownership plans). We find little evidence that nonprofit boards provide explicit incentives to CEOs to focus on altruistic activities. The results add to the collective evidence that for-profit and nonprofit hospitals are similar in many dimensions.”

Brickley and Van Horn

Compensation for CEOs of Human Services and “Other” Non-Profits

- Very similar between both groups

- Positive relationships:
  - Total program expenses*
  - Administrative efficiency
  - Commercial revenue
  - Investment portfolio

- Negative relationship:
  - Liquidity (for Human Services subsector)

- Not affected by:
  - Total fixed assets
Compensation for CEO’s of Religious Nonprofits

- Positive relationships:
  - Commercial-revenue share
  - Investment portfolio

- Negative relationship:
  - Administrative efficiency

Researchers’ Conclusions re Nonprofit CEO Compensation

- Compensation more sensitive to:
  - Organizational size
  - Free cash flows
  - Pay-for-performance a factor but not prominent

- In the absence of effective metrics of social performance and mission accomplishment, many organizations rely on other factors in setting compensation.

- Frumkin and Keating
Too Many Competing Interests on the Board?

“...we find that board size and the number of programs are negatively related to a nonprofit manager’s pay-performance sensitivities.”

Aggarwal, Evans, and Nanda

Questions

1. In your experience, do non-profit boards that use Policy Governance reward CEO’s based upon the level of achievement of “social performance and mission accomplishment”?

2. What are the challenges for boards using Policy Governance when they design CEO rewards programs?
DO INCENTIVES WORK? ARE INCENTIVES DELIVERING THE DESIRED RESULTS?
From the for-profit sector

Performance Leads to CEO Rewards

- Pay-performance sensitivity research:
  - Measured by change in CEO wealth after change in shareholder wealth
  - CEO wealth changes $3.25 to $14.25 per $1000 change in shareholder wealth
  - Modest movement in shareholder wealth can result in large swings in executive wealth
  - Future return on assets positively related to level of incentive pay.
  - Return on equity positively related to long-term incentive plans

Source: Cooper, Gulen, and Rau
But do Rewards Lead to Improved Performance?

Managerial Ownership and Firm Performance

- Mixed findings
  - Morck, Shleifer, and Vishny (1988)
    - Q ratios increase when 0-5% or greater than 25% of stock held by management
    - Q ratio decrease above 5% up to 25%
  
  - McConnell and Servaes (1990)
    - Q ratios increase until 50% management ownership
  
    - Shortfall of value-maximization smaller with larger CEO stockholdings
    - Results are enhanced in smaller firms
Managerial Ownership and Firm Performance

- Mixed findings (cont.)
    - Positive firm performance based upon % executive compensation and % executive ownership
  - Himmelberg, Hubbard and Palia (1999)
    - Changes in managerial ownership have little affect on performance

Results from the Extreme Ranges of Compensation

- One year after being classified into highest and lowest CEO compensation deciles:
  - Lowest earn insignificant returns
  - Returns for highest decile drop 4.38% in first year,
    - Average annual $2.39 billion shareholder losses after paying $22.7 million in total CEO compensation
    - 12.27% drop in returns by 5th year

“Our results seem most consistent with the hypothesis that over-confident managers accept large amounts of incentive pay and with the hypothesis that investors over-react to these pay grants and are subsequently disappointed.”

Cooper, Gulen, and Rau
The Need to Adjust the Formulae!

“Overall, CEOs own too little stock, too many options, and their options are insufficiently sensitive to risk.”

Habib and Ljungqvist,

The picture that emerges is one where a substantial fraction of companies operates under suboptimal incentives at any given point in time, but where boards also adjust incentives dynamically, perhaps as they update their beliefs about the CEO’s risk tolerance, ability, or cost of effort.

Habib and Ljungqvist
Questions

1. For a board using Policy Governance, how would you determine if incentives are actually motivating improved performance?

2. Given that Ends are typically longer term in their scope, should a non-profit board, using Policy Governance, seek to create longer term incentives?

HOW DO EXECUTIVES RESPOND TO INCENTIVES?

What are executives saying?
Research

*Making Executive Pay Work: The Psychology of Incentives*
- PwC and Dr. Alexander Pepper
- 1106 executive participants (not exclusively CEOs)
- 43 countries

Executive Perceptions of Bonus Risk

- 50% chance of $90,000 bonus or nothing
  Versus
- Certainty of $41,250
Complexity of Rewards

- The more complicated and ambiguous the long term reward, the less appealing to the executive.
  - “two-thirds more favoured a cash plan based on a condition that was internal to their organisation (earnings per share) over the more ambiguous share plan based on relative total shareholder return.”

Source: PWC

The Value of Future Rewards

- Longer waits are discounted by far more than the economics would indicate
  - Executives typically discount future uncertain rewards at 30% per annum

Source: PwC
Compensation Fairness

- Perceived fairness
  - The ultimatum game:
    - 50% of participants would offer the same as they would accept.
    - 1/3 more cautious
    - 15% more aggressive

- Pay in comparison to peers matters more than the actual amounts
  - Comparisons internally are generally more important than those externally.

*Source: PwC*

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Value of the LTIP versus Participation in the LTIP

**Value the opportunity to participate in long term incentive plan?**

- Agree
- Disagree
- Other

**Their firm’s long term incentive plan is an effective incentive?**

- Agree
- Disagree
- Other

*Source: PwC*
The Cost of Extrinsic Motivation

• The cost of keeping an executive
  • Extrinsic versus Intrinsic Rewards: Executives “prepared to take a
    28% cut for their own dream job”.

• Implication:
  • If too much of the compensation is variable pay, (“variable pay
    typically forms two-thirds of compensations for most senior
    executives”) how much extra cost is required to keep the
    employee?

  Source: PwC

  • “…on average boards had awarded options beyond the point where
    the marginal cost equals the marginal benefit of doing so.”

  Habib and Ljungqvist,

Nonprofit CEOs Want to Make a Difference…

“Making a positive difference to society and the community
is the biggest motivator for working in the nonprofit sector.”

“More than the responsibilities of the role, it is the mission
of the organization that is the biggest motivator for
executive directors.”

HR Council of the Nonprofit Sector
…But Remuneration is Important

• “One-half (49%) of [executive directors say they are
  making a personal financial sacrifice to work in their
  current job in the nonprofit sector.”

• “There is a higher sense of personal financial sacrifice
  among those who indicate they are only likely to remain in
  their position for up to two more years.”

  *HR Council of the Nonprofit Sector*

Questions

1. In your experience, how do CEOs of non-profits compare to the Executives in the PwC research?

2. What are the implications for non-profit boards using Policy Governance with regard to the design of rewards programs for CEOs?
Summary

1. **In practice, is compensation aligned with intended results?**
   - For non-profits, there is little evidence of rewards for results that are more challenging to measure (“social performance and mission accomplishment”).

2. **Do incentives work? Are incentives delivering the desired results?**
   - Mixed conclusions. For-profit boards usually base rewards upon performance; however, it is less clear how well performance is influenced by rewards.

3. **How do executives respond to incentives?**
   - Less risk appetite than might be expected
   - Complexity less appealing
   - Intrinsic motivation and extrinsic rewards need to be balanced

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