

# ROCK CENTER *for* CORPORATE GOVERNANCE

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## What is CEO Talent Worth?

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## GRADUATE SCHOOL OF BUSINESS

CLOSER LOOK SERIES: TOPICS, ISSUES, AND CONTROVERSIES IN CORPORATE GOVERNANCE

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## WHAT IS CEO TALENT WORTH?

### INTRODUCTION

The topic of executive compensation elicits strong emotions among corporate stakeholders, practitioners, and observers. On the one hand are those who believe firmly that chief executive officers in the United States are overpaid. They cite as evidence the large and growing disparity between total pay granted to CEOs and the compensation of the average worker.<sup>1</sup> Their solution is the encouragement of more shareholder activism (primarily through proxy measures, such as say on pay) to communicate concerns to companies and induce a voluntary reduction in compensation levels or stricter performance-based features that more closely align compensation to financial and operating results. Some go so far as to suggest that CEO compensation be regulated at a fixed multiple of the average worker's pay.

On the other side of the issue are those who believe that chief executives are paid the going fair-market rate. They argue that if compensation levels are high among the largest U.S. corporations, it is simply a reflection of the demands of a position that require considerable time, skill, and attention. They advocate continued disclosure on compensation size and structure so that market forces correct the mispricing of talent in situations where it arises.

Researchers have taken various approaches to evaluating whether CEO pay levels are appropriate. Gabaix and Landier (2008) measure the relation between CEO compensation and company size. They find that although CEO pay increased sixfold between 1980 and 2003, the market value of the companies these CEOs managed also increased sixfold during this period. They conclude that "the rise in CEO compensation is a simple mirror of the rise in the value of large U.S. companies since the 1980s."<sup>2</sup> Similarly, Kaplan and Rauh (2010) compare the growth

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<sup>1</sup> Although precise figures vary depending on the sample and methodology employed, one recent estimate pegs this ratio at 343 among a sample companies in the S&P 500. See AFL-CIO Executive Paywatch, available at: <http://www.aflcio.org/corporatewatch/paywatch/>.

<sup>2</sup> Xavier Gabaix and Augustin Landier, "Why Has CEO Pay Increased So Much?" *Quarterly Journal of Economics* (2008).

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rate of executive compensation to the growth rate of other highly paid professionals, such as hedge fund managers, private equity managers, venture capitalists, lawyers and professional athletes. They find that pay among these groups all grew by roughly the same order of magnitude during the period 1994 to 2005. They conclude that CEO compensation has increased due to market forces that contribute to general wage inflation among highly paid professionals, and that extreme compensation growth has not been limited to the business world.<sup>3</sup>

However, it is important to remember that demonstrating a correlation between executive compensation and firm size or performance does not mean that pay levels themselves are appropriate. It might still be the case that CEO pay itself is either too high or too low on average.<sup>4</sup> The only way to make a determination is to measure whether the total compensation received is commensurate with the value of services rendered. To do this, stakeholders need to understand 1) the value drivers of the organization, 2) the impact that the executive has on these value drivers, and 3) the percentage of value created that should be appropriately offered as compensation for performance. While this is simple in theory, it is exceptionally difficult in practice.

## PERFORMANCE AND COMPENSATION

The value drivers (or key performance indicators) of an organization include the financial and nonfinancial metrics that reflect the current and future performance of the company (see **Exhibit 1**). They might be generic in nature and applicable to most companies (such as revenue growth, profit margin, and return on invested capital) or specific measures that are relevant to a particular industry or line of business (such as research and development pipeline productivity or on-time delivery rates). Similarly, they might be readily quantifiable (such as product defect rates) or more qualitative in nature and therefore require proprietary methods of measurement (such as customer and employee satisfaction). It is the responsibility of management and the board of directors to identify the value drivers that are most critical to the success of the corporate strategy. This process is best accomplished through rigorous statistical testing that demonstrates a proven correlation between the relevant metric and changes in corporate value.<sup>5</sup> The valid performance indicators of the company then serve as the basis for measuring management performance and awarding compensation.

The challenge for the board is to determine what level of compensation to offer to chief executive officers for the achievement of specific performance objectives. This can be an

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<sup>3</sup> Steven N. Kaplan and Joshua Rauh, "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?" *Review of Financial Studies* (2010).

<sup>4</sup> Further complicating the matter is the fact that reported compensation figures in the proxy do not reflect what an executive has *earned* but instead combine cash compensation received plus a fair value estimate of the expected value of equity compensation granted. If performance does not meet expected results, the actual value of equity grants will be considerably lower than their original fair value. For a full discussion of this issue, see: David F. Larcker, Allan McCall, and Brian Tayan, "What Does It Mean for an Executive to 'Make' \$1 Million?" CGRP-22, Dec. 14, 2011, available at: [http://www.gsb.stanford.edu/cgrp/research/closer\\_look.html](http://www.gsb.stanford.edu/cgrp/research/closer_look.html).

<sup>5</sup> For a detailed review of this process, see: David F. Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences*, Chapter 6: Organizational Strategy, Business Models, and Risk Management (New York, NY: FT Press, 2011); and Christopher D. Ittner and David F. Larcker, "Coming Up Short on Nonfinancial Performance Measurement," *Harvard Business Review* (Nov. 2003).

extremely difficult task, not least of which because it is not always easy to determine how much corporate value creation should be attributable to the efforts of a single individual.<sup>6</sup> Although a considerable number of theorists and practitioners have argued that CEOs play a critical role affecting firm performance, the empirical research on this issue is mixed. 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 much greater: as high as 29.2 percent.<sup>7</sup> The view that board members have on this issue will have a substantial impact on what they view as reasonable CEO compensation (see **Exhibit 2**).

Finally, the board must determine the percentage of value creation to award in compensation. Although there are no agreed upon standards, observation of compensation practices among other talent pools might serve as a guide. For example, the CEOs that manage private-equity owned companies receive on average 5.4 percent of the equity upside (in the form of stock and options).<sup>8</sup> A-list actors in Hollywood receive \$10 to \$30 million per film, plus 10 to 20 percent of gross profits.<sup>9</sup> Music artists receive 8 to 25 percent of the suggested retail price of an album, a \$0.08 performance royalty when a song is played live or broadcast, plus a percentage of the gross profit generated on tour (see **Exhibit 3**).<sup>10</sup> Similarly, in setting compensation for CEO talent, the board should target a payout in relation to performance or value creation. In this regard, the structure of the compensation contract will be as important as its overall size.

## WHY THIS MATTERS

1. Executive compensation is a topic that is filled with much rhetoric (“nobody is worth \$20 million per year”) but somewhat less critical analysis (“maybe some CEOs are worth \$20 million per year while most others are not”). Why isn’t more of the discussion focused on the actual observable impact that a CEO has on value creation and the percentage of value that should be offered for these efforts?
2. Why don’t we commonly see *explicit* calculations of actual value creation by the CEO in proxy statements? Is it not possible for boards to perform this calculation? If not, how does the board make rational decisions regarding pay levels?

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<sup>6</sup> Sometimes it is even difficult to compute the value created by a firm. For example, does a one-year change in market capitalization validly reflect the change in value creation over the period?

<sup>7</sup> 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? (2005), available at SSRN: <http://ssrn.com/abstract=816065>.

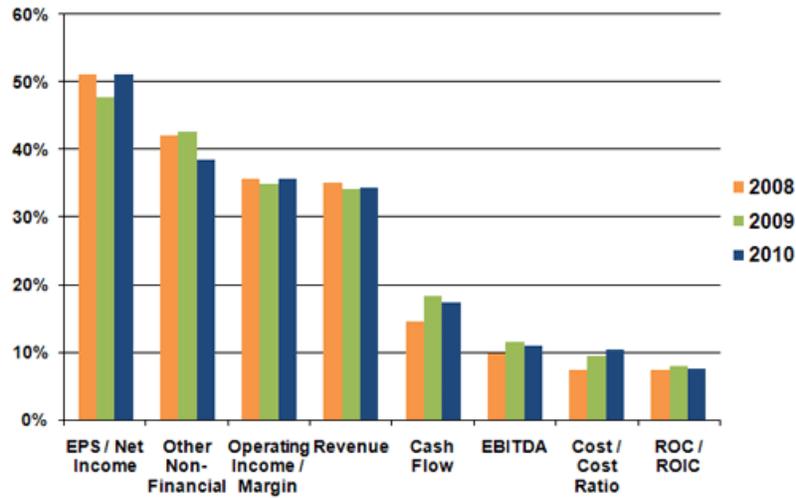
<sup>8</sup> Steven N. Kaplan and Per Strömberg. Leveraged Buyouts and Private Equity. *Journal of Economic Perspectives* (2008).

<sup>9</sup> Film Budgeting. Wikipedia.

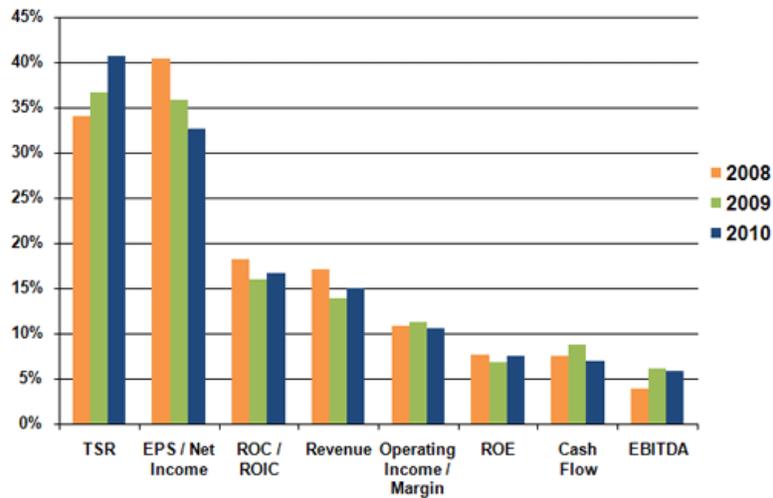
<sup>10</sup> Lee Ann Obringer, “How Music Royalties Work,” Available at: <http://entertainment.howstuffworks.com/music-royalties.htm>.

## Exhibit 1 Measures to Determine Corporate Performance (2008-2010)

### Metrics Used in Short-Term Incentive Plans



### Metrics Used in Long-Term Incentive Plans



Sample includes the most prevalent metrics in short- and long-term incentive plans for CEOs at S&P 1500 companies. Note that nonfinancial performance metrics are not a common feature of long-term plans.

Source: CEO Performance Metrics. Equilar. June 2011.

**Exhibit 2**  
**Compensation Levels of the Highest Paid CEOs (2010)**

| Name               | Company                | Salary      | Cash Bonus   | Stock        | Options      | Other     | Total        |
|--------------------|------------------------|-------------|--------------|--------------|--------------|-----------|--------------|
| Phillipe Dauman    | Viacom                 | \$2,625,000 | \$11,250,000 | \$41,833,309 | \$28,620,000 | \$141,206 | \$84,469,515 |
| Ray Irani          | Occidental Petroleum   | 1,191,667   | 32,975,000   | 40,250,000   | 0            | 1,690,343 | 76,107,010   |
| Lawrence Ellison   | Oracle                 | 250,001     | 6,453,254    | 0            | 61,946,500   | 1,493,320 | 70,143,075   |
| Leslie Moonves     | CBS                    | 3,513,462   | 27,500,000   | 7,999,982    | 14,868,000   | 2,977,722 | 56,859,166   |
| Richard Adkerson   | Freeport McMoRan       | 2,500,000   | 10,000,000   | 5,818,492    | 15,420,000   | 1,555,531 | 35,294,023   |
| Michael White      | DirecTV                | 1,448,077   | 4,000,000    | 14,690,396   | 12,497,196   | 296,949   | 32,932,618   |
| John Lundgren      | Stanley Black & Decker | 1,208,433   | 4,342,800    | 25,347,725   | 1,255,500    | 416,138   | 32,570,596   |
| Robert Iger        | Walt Disney            | 2,000,000   | 13,460,000   | 7,359,060    | 4,399,991    | 798,433   | 28,017,484   |
| Brian Roberts      | Comcast                | 2,800,761   | 10,922,968   | 5,308,989    | 5,917,380    | 3,205,767 | 28,155,865   |
| Alan Mulally       | Ford Motor             | 1,400,000   | 9,450,000    | 7,492,493    | 7,499,993    | 678,029   | 26,520,515   |
| Jeffrey Bewkes     | Time Warner            | 2,000,000   | 14,420,000   | 5,519,056    | 4,073,646    | 124,129   | 26,136,831   |
| Samuel Palmisano   | IBM                    | 1,800,000   | 9,000,000    | 13,319,450   | 0            | 1,061,231 | 25,180,681   |
| Gregg Steinhafel   | Target                 | 1,500,000   | 5,301,000    | 8,017,549    | 3,189,299    | 5,501,346 | 23,509,194   |
| David Farr         | Emerson Electric       | 1,187,500   | 2,200,000    | 19,081,600   | 0            | 474,865   | 22,943,965   |
| Wesley Bush        | Northrop Grumman       | 1,334,615   | 3,037,500    | 8,349,848    | 7,155,028    | 2,272,297 | 22,149,288   |
| Howard Schultz     | Starbucks              | 1,280,804   | 3,500,000    | 10,499,986   | 6,220,559    | 231,664   | 21,733,013   |
| William Weldon     | Johnson & Johnson      | 1,851,154   | 12,043,200   | 2,773,851    | 4,713,177    | 254,436   | 21,635,818   |
| Kevin Sharer       | Amgen                  | 1,748,846   | 3,635,000    | 8,306,025    | 6,691,367    | 756,895   | 21,138,133   |
| Rex Tillerson      | ExxonMobil             | 2,207,000   | 3,360,000    | 15,465,375   | 0            | 443,921   | 21,476,296   |
| Michael Szymanczyk | Altria                 | 1,300,000   | 14,002,500   | 4,975,000    | 0            | 495,910   | 20,773,410   |

Note: Total compensation excludes changes in pension value and non-qualified deferred compensation.

Source: Equilar

**Exhibit 2 (continued)**  
**Compensation Levels of the Highest Paid CEOs (2010)**

| Name             | Company                | Reported Pay | Disclosed Performance Metrics   | 5 Yr TSR v. Peers    |
|------------------|------------------------|--------------|---|----------------------|
| Phillipe Dauman  | Viacom                 | \$84,469,515 | Operating income, free cash flow, strategic initiatives, ratings, cost reduction, corporate goals, compliance, and policy objectives                                | -3.5%<br>v.<br>-7.8% |
| Ray Irani        | Occidental Petroleum   | 76,107,010   | TSR, net income, EPS, governance, functional and operating accomplishments, health and safety, diversity, organizational development                                | 168%<br>v.<br>56%    |
| Lawrence Ellison | Oracle                 | 70,143,075   | Pre-tax profit growth   | 78%<br>v.<br>16%     |
| Leslie Moonves   | CBS                    | 56,859,166   | OIBDA, free cash flow, ad revenue growth, leverage, contract negotiations, Nielsen ratings, content, other strategic and operating metrics                          | -9%<br>v.<br>-8%     |
| Richard Adkerson | Freeport McMoRan       | 35,294,023   | Operating cash flow, return on investment, safety performance   | 109%<br>v.<br>26%    |
| Michael White    | DirecTV                | 32,932,618   | Net subscriber growth, CFBIT, OPBDA, revenue, EPS, churn, ARPU, acquisition cost, market share, new products, customer loyalty, cost management, talent development | 196%<br>v.<br>-1%    |
| John Lundgren    | Stanley Black & Decker | 32,570,596   | EPS, cash flow multiple, TSR, return on capital   | 49%<br>v.<br>22%     |
| Robert Iger      | Walt Disney            | 28,017,484   | Operating income, return on capital, cash flow, EPS, content quality and innovation, brand building, talent development, integration                                | 55%<br>v.<br>-5%     |
| Brian Roberts    | Comcast                | 28,155,865   | Operating cash flow, free cash flow, revenue growth   | 34%<br>v.<br>36%     |
| Alan Mulally     | Ford Motor             | 26,520,515   | Profit before taxes, cash flow, cost management, market share, product quality, functional and technical excellence, teamwork, modeling values                      | 112%<br>v.<br>19%    |

Note: Reported pay represents the fair value of compensation granted during fiscal year 2010, excluding change in pension value. Disclosed performance metrics include those discussed in the annual proxy. Five year total shareholder return (TSR) as reported in the annual proxy or form 10-K, or calculated by the authors for those companies that did not disclose these figures. In some cases, the tenure of the current CEO is less than five years.

Source: Equilar, Securities and Exchange Commission, Yahoo! Finance.

### Exhibit 3 Compensation Levels among Highly Paid Professionals (2010)

#### Highest Paid Actors

| Name              | Earnings     |
|-------------------|--------------|
| Leonardo DiCaprio | \$77 million |
| Johnny Depp       | 50 million   |
| Adam Sandler      | 40 million   |
| Will Smith        | 36 million   |
| Tom Hanks         | 35 million   |
| Ben Stiller       | 34 million   |
| Robert Downey Jr  | 31 million   |
| Mark Wahlberg     | 28 million   |
| Brad Pitt         | 20 million   |
| Robert Pattinson  | 20 million   |

#### Highest Paid Actresses

| Name                 | Earnings     |
|----------------------|--------------|
| Angelina Jolie       | \$30 million |
| Sarah Jessica Parker | 30 million   |
| Jennifer Aniston     | 28 million   |
| Reese Witherspoon    | 28 million   |
| Julia Roberts        | 20 million   |
| Kristen Stewart      | 20 million   |
| Katherine Heigl      | 19 million   |
| Cameron Diaz         | 18 million   |
| Sandra Bullock       | 15 million   |
| Natalie Portman      | 8 million    |

#### Highest Paid Musicians

| Name            | Earnings      |
|-----------------|---------------|
| U2              | \$195 million |
| Bon Jovi        | 125 million   |
| Elton John      | 100 million   |
| Lady Gaga       | 90 million    |
| Paul McCartney  | 67 million    |
| Black Eyed Peas | 61 million    |
| Justin Bieber   | 53 million    |
| Toby Keith      | 50 million    |
| Usher           | 46 million    |
| Taylor Swift    | 45 million    |

#### Highest Paid Athletes

| Name              | Earnings     |
|-------------------|--------------|
| Tiger Woods       | \$75 million |
| Kobe Bryant       | 53 million   |
| LeBron James      | 48 million   |
| Roger Federer     | 47 million   |
| Phil Mickelson    | 47 million   |
| David Beckham     | 40 million   |
| Cristiano Ronaldo | 38 million   |
| Alex Rodriguez    | 35 million   |
| Lionel Messi      | 32 million   |
| Tom Brady         | 31 million   |

Source: Forbes, "The World's Most Powerful Celebrities," 2010. Available at: <http://www.forbes.com/wealth/celebrities>.