



What Happens When the Press Blasts Your CEO for Excess Compensation? Apparently Not Much

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Springtime, in addition to bringing back flowers and birds, also brings forth many companies' proxy statements, including information on CEO compensation. It's a signal for the business press to get to work reporting the details of what appear to be the highest executive pay packages.

Wharton accounting professors [Wayne Guay](#) and [John Core](#), and Stanford accounting professor David Larcker, also study executive compensation. What they conclude from their most recent research is that the most relevant information does not necessarily make headlines. They also find that in general, the media's focus on excessive compensation does not substantively change corporate behavior with regards to pay packages.



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Big Numbers vs. Small Numbers

"When we look at executive compensation, we use economic models that benchmark CEOs against their counterparts in similar firms, controlling for various characteristics like the size of the firm and the competitive environment that the firm operates in," says Guay. "With this information, we then try to estimate who is getting overpaid or underpaid, which firms have governance problems or issues related to stock options, and so forth. The press might use some of the same models to try and place compensation packages in context, or they may focus instead on producing stories people will find interesting. That might include writing about a person everyone has heard of, even if he or she is not necessarily overpaid."

Guay says he appreciates the balance the press tries to achieve between its role as a watchdog and its desire to offer articles that the public wants to read. For example, he suggests that the composition and competence of corporate boards are important topics for the press to cover, and in fact these issues do get some attention. But "the problem is, they are less sexy than executive compensation. After all, everyone gets a paycheck, and can easily compare their own pay packages to the much-bigger pay packages of many CEOs."

Guay and his colleagues raise these issues in a recent article titled, "The Power of the Pen and Executive Compensation." What models, they ask, are used by the media "to select CEOs for negative articles about their compensation, and do firms and managers find this attention sufficiently costly that they respond by making changes to their compensation policies?"

Relying on 15,000 press articles about CEO compensation from 1994 to 2002, the researchers find "mixed evidence on the level of sophistication used by the press to select companies for negative press coverage. While such coverage is more strongly related to measures of excess total annual pay than to raw total annual pay, coverage is also related to CEO options exercises and total stock and option holdings." By raw annual pay, the researchers mean the total amount of annual pay received by an individual. Excess annual pay is compensation in excess of a benchmark level of pay as derived from such determinants as size of firm, compensation relative to peers, industry, and quality of management.

In addition, the press often focuses on large payouts from multi-year compensation programs, and regards

exercised options as a component of annual pay rather than the value of options at the time they are granted, Guay notes, suggesting that this demonstrates "business illiteracy or lack of sophistication. If I grant someone \$1 million in options every year, and that executive decides to exercise all those options at one time, you are going to have a big number. If the press reports that number as the amount of money the CEO took home in one year from exercising options, I would consider this to be sensationalizing the news. It's not a year's pay; it's five, six or seven years of options in one shot. I assume the press knows this, but their readers like to look at really big numbers rather than small numbers."

The researchers also find that negative publicity over compensation is more intense at larger companies and poorly-performing ones. They interpret this as a sign the press is hyping the news to appeal to as broad a readership as possible.

As for the lasting impact of bad press on CEO compensation, the authors find "mixed evidence" that it motivates firms to substantially change their compensation practices. In general, it does not prompt drastic cutbacks in compensation because CEO compensation decisions are "largely insensitive" to negative publicity, they note.

Instead, the authors found minor cosmetic changes: CEOs do reduce option exercises and firms reduce cash pay as a proportion of total pay after receiving negative press. "Our results are inconsistent with the recent evidence that the media exerts an important influence on corporate governance choices," the authors say.

"Gaining" vs. "Pocketing" Millions

How the authors define negative press coverage is both scientific and subjective. To identify a "search string" of negative words and phrases, the researchers read approximately 200 articles on CEO compensation, some on randomly selected firms and others on firms widely known to have received negative publicity (including Tyco, Citigroup, Hewlett Packard, eTrade, Quest and Disney).

This initial search string helped cull the negative articles from the neutral ones. But the authors also read through and evaluated an additional 50 articles, using their findings to further tweak the search string. "It was fairly subjective on our part as to whether an article was negative-toned," acknowledges Guay. "We didn't want to leave the reader thinking that this was pure science."

As an example of nuances in coverage, the authors point to two articles about the 2001 compensation package of eTrade Financial CEO Christos Cotsakos. Both articles were published on May 1, 2002.

The first article, from *The New York Times*, reports the salary, bonus, equity, and other components of Cotsakos's pay package without taking a view as to whether the pay package is excessive or unreasonable. The authors classify this article as having a non-negative tone. The second article, this one from the *Wall Street Journal*, also reports the components of Cotsakos' pay package but the authors note that it takes a negative tone by calling the compensation an "outsize package" and referring to Cotsakos as the "highest-paid CEO on Wall Street."

The key word "outsize" within a few words of "salary" and/or "bonus," and the key word "highest" within a few words of "pay" are both triggers for the key word search for negative tone. A more subtle negative jab at Cotsakos could be found in the newspapers' choices of verbs. In the *New York Times*, Cotsakos "gained \$11 million by exercising stock options." In the *Journal*, he "pocketed \$11 million."

Based on a measure constructed by the authors, Cotsakos of eTrade Financial was among the top five CEOs in 2001 with the greatest excess pay, receiving \$93.9 million in total compensation, and he was the target of 38 negative articles.

According to the authors, there is no predictable explanation as to why a few other excessively paid CEOs avoided media attention. For example, Dwight Schar of NVR received \$59 million in total pay, landing him among the group of CEOs with the greatest excess pay in 2001, yet escaped negative publicity. Part of the reason may be because of NVR's outstanding stock return performance (a +571% three-year market-adjusted return) and relatively small size (\$1.5 billion in market capitalization).

However, Greg Reyes, CEO of Brocade Communications, who received about \$370 million in 2001 total compensation (the majority of which reflected excess pay), also escaped negative publicity despite a -92% market-adjusted stock return performance over the prior three years. "From what we could tell, there was no press attention on this. Why? Because it's a small company and the CEO had been there a fairly short period of time," says Guay. In addition, the compensation was primarily from stock options. For the press to have come up with the \$370 million figure, it would have had to value those options. That valuation can be opaque. In our case, we valued the options ourselves, and didn't rely on the proxy statement's estimate of the options."

Not surprisingly, the authors found that company size determines press scrutiny. Nine of the 10 CEOs who received negative publicity over their excess compensation actually were among the least over-paid, according to the authors. But these CEOs ran very large companies. "If a company is not a household name because it sells industrial products, for example, then identifying that CEO's excess pay will have narrow readership," says Guay. "But a company selling consumer products -- donuts, video games, things everyone has heard of -- will draw more attention."

Dennis Kozlowski of Tyco International received the most negative articles -- 243 -- in 2002. His total compensation in 2001 was \$77.8 million, a substantial portion of which was estimated by the authors to be excess compensation. Carly Fiorina, former CEO of Hewlett Packard, received the second highest number of negative articles in 2002. Her excess compensation was actually negative (meaning she was underpaid relative to her peers), but she was the recipient of considerable criticism about the company's sub-par performance as evidenced by its market-adjusted stock return of -68% between 2000 and 2002.

Window into Corporate Governance

There is much more ground to cover in studying the role of the media in business decisions. For example, the authors make no distinction between articles written by the business press, such as the *Wall Street Journal* and *Barron's*, and national newspapers such as *The New York Times* and *Washington Post*, and regional newspapers such as the *Atlanta Journal Constitution* and *Philadelphia Inquirer*. Nor in this paper did they look at how local coverage in a company's hometown newspaper may differ from national coverage. "We haven't figured out how to digest local information when it applies to a global corporation," says Guay.

For many reasons, Guay expects executive compensation to remain a hot topic for the press -- and for researchers. But he points out that excessive compensation is not, in and of itself, an evil. "In the vast majority of cases where CEOs are overpaid, the amount of overpayment has a trivial impact on the stock price," he says. "If you overpay a CEO by \$3 million to \$5 million a year in a \$40 billion company, that just doesn't have much impact on investors."

At the same time, Guay adds, "people look at executive pay as a window into the governance system. If the CEO's pay is out of whack, it's more likely there are more governance problems deeper within the organization. And governance problems can result in big losses in shareholder value."

Do the authors have any recommendations for improving press coverage? "I would encourage reporters to make a distinction between option exercise and pay," says Guay. "The option exercise gets large only after the CEO or the firm has done well. If a CEO is granted options now, he or she can't exercise them unless the stock price goes up substantially. So option exercises are simply not pay. We are not the first

ones to say this. Option exercises need to be treated separately. A lot of times you see 'highest-paid executive surveys' that include option exercises as a component of pay. That would be like people getting criticized for excess pay at the time they retire because they decided to take their entire pension or 401(k) as a lump sum that year."

Guay also suggests that reporters "filter out some of the firm characteristics. Bigger firms in industries that are more difficult to manage tend to attract higher quality executives and they have to be paid more," a distinction that the press doesn't always make. For example, "one of the reasons Fiorina was hit pretty hard by the press in terms of compensation was because of a lot of layoffs and downsizing, and yet sometimes the individuals who make those tough decisions will get compensated for it. That can be hard for company employees -- and the press -- to swallow. Here is an individual who just fired 10,000 people and yet just got a big bonus. But firing 10,000 may be the only way to make the company survive. Bringing in a turnaround specialist at a struggling firm costs a lot of money. No one wants to do that job unless he or she will be well compensated for it. In addition, you have to compensate top management well to make sure they don't jump ship."

Other industries that operate in volatile environments and require high quality executives include biotech, software, telecommunications and pharmaceuticals, among others. Contrast these to running heavily regulated local utility companies, says Guay, "which typically don't require the same type of talented, high-quality management."

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