# Are U.S. CEOs Overpaid? A Partial Response to Kaplan

by James P. Walsh

Professor Steven Kaplan and I have had a spirited public conversation about CEO compensation and the responsibilities of the business scholar to society (Kaplan, 2008a; Walsh, 2008; Kaplan, 2008b). We differ in our assessments of whether or not CEOs are overpaid, paid for performance, and dismissed for poor performance; we also hold very different views of our professional responsibilities. I am grateful for the opportunity to offer a few words in response to Professor Kaplan's most recent remarks. The key words here are "few words." I am bound by the rules of debate. These kinds of conversations cannot go on forever. Indeed, the rules say that the first author has the last word. I am able to respond Professor Kaplan only because I offered new data in my essay. That makes me something of a first author too. I can respond to his comments about my empirical research, and no more. There are three issues in play.

## Are CEOs Highly Paid?

We both agree that CEOs are highly paid. As Professor Kaplan said, "This is not in dispute" (2008b, p. 29). Unfortunately, our total agreement notwithstanding, we still have a problem. It turns out that I made a mistake when I shared some data to illustrate just how much money these executives take home. I collected data on the CEOs of the 1,000 largest public firms in the United States (ranked by sales) in 2005 and reported that they earned $9.025 billion in 2005. That is correct. I said that this sum sits between the 2005 GDPs of Myanmar ($8.90 billion) and Bolivia and Jamaica (tied with $9.71 billion). That too is correct. But I also said that each of these CEOs claimed, on average, 7% of his or her firm's total sales (Walsh, 2008, p. 26). That is not correct. Professor Kaplan (2008b, p. 29) saw the mistake immediately and guessed that I inflated my results by a factor of 70. It turns out that I was off by a factor of 100.

I computed the total compensation of the top 1,000 CEOs in 2005 to be $9,025 million; their firms' total sales were $12,745,140 million. Dividing one by the other gives us 0.0007 or 0.07%. I have no idea how .07% turned into 7% in the final draft, but it did. Nor do I know how I missed this mistake. I knew that Bebchuk and Grinstein (2005), for example, reported that the top five executives in their sample of public companies a few years earlier were paid 9.8% of their firms' aggregate earnings. I should have seen that no one in that group could claim 7% of sales on average.[1] I am glad to be able to set the record straight here.

## How Should We Account for New Options?

Professor Kaplan believes that we should ignore new option grants and compute only the value of exercised options when we calculate CEO pay. I disagreed and still disagree. He claims that by tracking new and exercised options, we effectively double-count the option value (the CEO is paid with the new options and then paid again when he or she exercises them). Yes, this is a tricky issue. Nevertheless, I believe it is important to track both (Walsh, 2008, pp. 27–29). He worries

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[1] While I bear full responsibility for this miscue, it is interesting to observe that none of the early readers caught the error either. That may reflect just how inured we have become to the magnitude of CEO pay.

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about double-counting; I worry about missing the motivational properties of the new option grants.

Compensation serves as both a reward (exercised options) and an incentive (options granted). CEOs will certainly estimate the value of any new option grants. If a board gives a CEO one million new options, that CEO is quite aware of their likely value and the fact that he or she received one million options and not 500,000 or two million. Do those new options have motivational properties? Of course they do. For example, they can affect how CEOs view the rest of their compensation packages (Ofek & Yermack, 2000), as well as the operating decisions they make (Datta, Iskandar-Datta, & Raman, 2001; Sanders, 2001). Should we ignore them? I say no, and I am not alone. Core, Guay, and Larcker (2008, p. 4), for example, recently observed that "economists generally view the grant value of stock options as a more appropriate measure of CEO option-based pay than ex post realized proceeds from multi-year grants."[2] If you had to pick just one to assess annual CEO compensation, the prevailing wisdom is to compute the value of the new options, not the exercised options. Nevertheless, like Core et al. (2008), I decided to track the separate effects of both. Doing so, Professor Kaplan accused me of obfuscating the debate about CEO pay (2008b, p. 30). On the contrary, I tried to provide as much information as I could about a complex subject. In fact, by ignoring the motivational properties of new option grants, he may be the one guilty of obfuscation.

## How Are We to Assess Firm Performance?

Professor Kaplan looked to his own working paper and told Congress that there is a strong link between pay and performance. I pointed to the vast literature on this question and said that the evidence was far more mixed than he allowed. I then collected some data to illustrate my point. In his response, Professor Kaplan criticized the way I measured firm performance (questioning my one-year snapshot of a firm's ROA). How are we to assess firm performance?

Professor Kaplan suggested that we look at size-adjusted and industry-adjusted historical stock prices. Fair enough. That choice gives us one glimpse at the pay/performance relationship. I chose ROA. Of course, others have looked at all manner of other measures of performance. Dalton, Daily, Certo, and Roengpitya (2003), for example, published a meta-analysis of 60 studies that looked at the relationship between a CEO's equity and firm performance. They discovered that past CEO compensation scholars assessed firm performance using Tobin's Q; adjusted and unadjusted measures of ROA, ROE, and ROI; shareholder returns; earnings per share; market-to-book ratios; and price-to-earnings ratios.[3] These scholars had their reasons for assessing firm performance in so many different ways. I simply picked one of them to illustrate that the pay/performance relationship might not always be as strongly positive as Professor Kaplan suggested. Are size- and industry-adjusted historical stock prices the best measure of firm performance? Maybe. I simply imagined that the American public might like to know how his approach and results compared to the methodological choices and empirical results other scholars have reported in this research domain over the years. The issue is far more complicated than he allows.

Those who read our debate closely might wonder what I have to say about a variety of other issues. For example, Professor Kaplan seems very attracted to the dynamics of winner-take-all labor markets (Frank & Cook, 1995). We could talk about their properties and even the idea that "market forces" can, or should, serve as an account for life's mysteries (Cox, 1999). Professor Kaplan was not impressed by my introduction of *Parade* magazine's annual compensation survey to this conversation. We could talk some more about how institution theorists might use a magazine

[2] Pointing to the problem with recognizing exercised options, Core et al. (2008) went on to argue: "For example, consider a CEO who is granted stock options each year for five years. If this CEO chooses to exercise all of these options in the fifth year, it would be inappropriate to infer that the CEO received no option compensation in the first four years when the options were granted, and substantial option compensation only in the fifth year when the options are exercised" (p. 4).

[3] Incidentally, the effects are as modest as they are mixed. The meta-analysis-corrected correlation population estimates ranged from -.11 in the six studies that examined industry-adjusted ROE to .09 for the 10 studies that looked at ROA.

like this to help us understand CEO compensation practices (Meyer & Rowan, 1977; Westphal & Zajac, 1994).[4] And dismissing my concern that some might see a conflict of interest in his Congressional testimony, Professor Kaplan turned my question about our professional responsibilities into a question about which of us is a better scholar. We could certainly talk about that too. Perhaps these conversations are best left to the imagination. I am grateful for the opportunity to respond as I can. I sincerely hope that our debate stimulates our readers to consider, if not reconsider, their views of U.S. CEO compensation practices.

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[4] I drew attention to the compensation of Kerry Killinger, the longtime Washington Mutual CEO who has since presided over the largest bank failure in American history (Sidel, Enrich, & Fitzpatrick, 2008). *Parade* magazine's 71 million readers may have wondered again about Mr. Killinger's multimillion-dollar compensation package when they heard that news.