Does a CEOs remuneration package positively impact a companys performance?

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Chief Executive Officer's (CEO) compensation has been a major topic of concern in the past decades, with most of the talk mainly focussing on the high level of compensation and the scandals that follow. A CEO, which is a high ranking position in a company, is responsible for the strategic direction and the growth of the company. The exact role and duties performed by a CEO are dependent on factors such as the size and the structure present at a company. However, a CEO is generally responsible for managing operations, culture and vision of the company. The impact of a CEO is usually felt when a new CEO is employed. The approach and direction taken by different CEOs are likely to differ, and in some cases can cause employees to become unsettled as different strategies may not require certain positions. The stock price is also likely to be affected as the market familiarises itself with the new CEO, and their ability to effectively run the company. Perception is a major driver of stock prices. Some issues that could cause the price to tumble are the reputation and track record of the CEO. The CEO's intents and investors' uncertainty of the CEO's grasp of factors associated with the company's industry and the trouble the company might be facing are issues of concern. It is thus very important for companies to attract, retain and motivate productive CEOs that will spur on company growth and achieve company goals and targets.

A big worry for a company's board of directors or shareholders is whether or not the CEO will act in their interest or his/her own personal interests, aka the principal-agent problem. This is usually a problem when the CEO receives fixed pay and knows that regardless of performance their compensation is guaranteed, thereby luring the CEO to moral hazard. Companies thus must seek corporate governance structures that minimise these inefficiencies and reduce moral hazard, by tying the CEO's interests to outcomes in line with the expectations of the board of directors and shareholders. Companies thus give CEOs incentives linked to the performance of the company. Such practices, however, may induce a short-term mindset where the CEOs focus strategies on meeting short-term targets, which may adversely affect long term goals. A study by Alex Edmans showed that the introduction of performance-related incentives led to a 44% increase in productivity.

A common way to track the performance of a company is to use a company's long-run stock price, as it encapsulates all relevant information regarding the company. This is dependent on the efficiency of the market or stock exchange. The level of regulation present will affect both of these. However, on average, the stock price incorporates past and projected price movements, past and projected profits, growth opportunities, the culture of the company, satisfaction of consumers, company's competition, just to mention a few. A research study carried out by Alex Edmans showed that companies viewed by employees in a positive light outperformed the rest by 2-3% annually. Francis and Fuhrmans also found that a fifth (20%) of CEOs with the highest shareholder return received the highest pay.

There is a large number of research studies that have been conducted over the years regarding the relationship between CEO pay and company performance. However, the results have been contradictory with some failing to find positive relationships between the two, whilst others have.

A study conducted by Basuroy et al (2014) failed to find a relationship between a CEOs compensation and the value of the firm, as well as CEOs compensation and the satisfaction of customers. Randoy and Nielsen (2002) also failed to find a statistically significant relationship between CEO compensation and company performance based on stock or accounting ratios performance in Scandinavian companies. However, when they assessed performance on the basis of a combination of accounting ratios and stick performance, a weakly positive but significant relationship emerged. In addition to this, they found that CEO compensation increased with the size of the board, the number of foreign board members, and market capitalisation, whilst it decreased with the level of equity owned by the CEO. This is supported by the paper by Bonsu and Lutta (2016) whose study on emerging markets failed to find any relationship between CEO pay and company performance but found a positive relationship between CEO pay and the size of the company. An interesting study by Wald et al (2006) found evidence of cronyism, i.e. hiring employees on the basis of friendships and not on the ability to perform. They found that CEO compensation was significantly associated with underperformance and not improved performance. The results for this study were in line with those of Banker et al (2013), who found that CEO’s bonuses, which are adjusted to curb moral hazard, had a negative relationship with past performance. Banker et al (2013) did, however, find that a CEO’s salary had a positive relationship with past performance.

In contrast, Hall and Liebman (1998), who looked at the 15 year period from 1980 to 1994 found that a strong positive relationship does exist between a CEO’s compensation and the performance of the company. Their results have been supported by studies by Chen and Ma (2011), as well as, Jensen and Murphy (2010). A study by Lindström and Svensson (2016) failed to find a relationship between CEO variable compensation and the performance of the company when assessing companies as a whole. However, their study revealed a positive relationship when considering specific industries. In particular, this relationship was found in the Healthcare and the Financial industries.

It is clear that some inconsistencies exist where the relationship between CEO pay and company performance is concerned. There is thus a need for more research studies with refined methodologies to potentially draw out clearer relationships. However, the majority of the results show that linking CEO compensation to the performance of the company does not have the desired effect, i.e. it does not effectively solve the principal-agent problem.

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