CEOs who are good matches for firms have higher initial compensation, study finds

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(Phys.org) —How much CEOs are compensated is often a subject of angst in the media and among the public. When a company's board of directors hires a new chief executive, it's often perceived that the level of compensation is not based on the value of the CEO to the firm, but on other factors—such as how many connections the new hire has on the board.

A recent study from the University of Nebraska-Lincoln provides evidence, however, that CEOs who turn out to be successful are the ones who are offered higher compensation packages from their boards at the outset.

The research, authored by Sam Allgood and Kathleen A. Farrell of UNL's College of Business Administration, examined the tenures of more than 1,400 CEOs over a 14-year period to determine if initial CEO compensation is related to how well an executive fits the job to which they were hired.

They found that leaders who turned out to be good fits at their companies—defined as those with tenures of four years or more—were those who enjoyed clearly higher compensation packages at the start of their tenures. CEOs who stayed in office at least four years, the study found, made about 18 percent more on their initial contracts than those whose tenures lasted less than four years.

The study highlights the growing importance of board independence and clearer access to consistent information about executive job candidates from both within and outside a company, the authors said.

"Initial compensation packages are the most important contracts negotiated by boards because CEOs rarely take pay reductions," said Allgood, a professor of economics. "So it's important to know whether or not these initial contacts reflect the potential value of the match between CEOs and their firms."

The researchers assigned four years as a "good match" because most CEO turnover happens early in an executive's tenure, when the firm realizes the person is not a good fit. It's unlikely a CEO would become a bad fit in this short time because of changing firm strategic goals—unless he or she was hired to initiate these changes. A CEO also would not become entrenched over such a short amount of time, but four years left enough time for CEOs and firms to learn if their fit was a good one, according to the study.

The researchers also examined the difference in initial compensation packages for CEOs promoted from within the firm compared with those who were recruited from the outside. The ability of a firm to identify good CEO matches, they said, depended upon the information available when a new hire is made.

The authors theorized that boards have more information about CEOs hired from within the firm than for CEOs hired from outside the firm. They found that at the outset, longer-tenured, internally promoted executives made an average of 26 percent more than internally promoted executives who left their companies before four years were up. However, the initial pay of CEOs hired from outside the firm was the same whether or not the CEO was a good match or a bad match with the firm.

"If boards are effectively evaluating new hires, the new hires that were a better fit for the firm should be paid more," said Farrell, a professor of finance.

To account for regulatory and economic changes, the study was broken into three phases: 1992 to 1997; 1998 to 2002; and 2003 to 2006. Though the relationship between match quality and initial compensation persisted across all of the time periods, the study also found that the number of good matches for both inside and outside CEOs became much more similar after 2002.

The increased similarities in good matches with inside and outside CEOs in recent years suggests that boards have become better able at obtaining comparable information about outside candidates. This may be result of increased board independence and changes in the corporate regulatory environment following the 2002 passage of the Sarbanes-Oxley Act, which set or enhanced standards for all U.S. public company boards, management and public accounting firms.

The study was published in the *Journal of Corporate Finance*. In addition to Allgood and Farrell, it was co-authored by Rashiqa Kamal of the University of Wisconsin-Whitewater.

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