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CEO: Greater the risk, bigger the payoff

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CEO paychecks increased sixfold between 1980 and 2003. A number of key issues explain how executives in tech firm justify their six figures.

The words "CEO compensation" in today's post-Enron age are likely to inspire pay rage. The top 20 highest paid executives in U.S. public companies made an average of $36.2 million in 2006, essentially triple that of their European counterparts.

Most people are aware that CEO salaries have increased steadily since 1980, in line with the companies they manage. While the correlation between growing firms matched by growing salaries seems obvious on the surface, there is little research on the internal and external influences that play a role in executive compensation.

Why do North American CEOs average much higher salaries than European ones, even though European bosses manage companies that are 40 percent bigger than North American firms? Which factors give American CEOs such bulging bank accounts?

In their paper, "Executive Compensation in North American High-Technology Firms: A Contextual Approach," IESE Prof. Pascual Berrone and professors Marianna Makri and Luis Gomez-Mejia take a comprehensive look at the link between executive compensation and innovation in North American tech firms. Shunning the traditional profit-based approach, the authors examine the range of variables that exert influence over these firms' business models, and thus, their compensation schemes.

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The R&D payoff factor

In studying North American tech firms, the authors put innovation at the top of the list of variables affecting CEO pay. Research and development, indeed a risky investment, is often responsible for company growth spurts and market domination. Since CEOs ultimately make the final decision over which projects and investments to undertake, appealing incentive schemes can induce senior management to engage in innovative projects leading to new products, higher efficiency and/or market control.

With the R&D payoff factor in mind, the paper suggests several propositions that can be used to understand how outside forces exert influence over compensation schemes in technologically intensive firms. In addition, the body of work presented in this paper is meant to assist future researchers studying agency theory, or the relationship between shareholders and executives.

Special emphasis is placed on family-owned and run businesses, thereby giving researchers a wider view of compensation packages created by these special types of firms. In the tech sector, many firms, including Microsoft and HP, got off the ground thanks to strong family interest and investments.

"The design of compensation packages in family firms that belong to technologically intensive sectors is an issue that has been obliquely studied at best," the report states. "Because of the importance of family firms in incubating and financing new ventures, and their central role in stimulating economic and technological progress, we examine the role of incentives in high-technology firms when family ties are present."

Four key factors

Four contextual factors play a key role in compensation plans for senior level executives:

*The North American Legal System***.** When speaking of technology, the patenting process is of paramount importance. Legal efficiency ensures that firms can invest in innovation and development, while providing anti-trust protection and safeguarding intellectual property rights. Because of these protection standards, firms adopt a preference for innovation quality over quantity as payoff criteria, and they exhibit greater financial measures in short-term and long-term pay, the latter resulting in larger salaries for CEOs and upper management.

Government Intervention and Legislation. The government plays an equally important role

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through legislation, particularly regarding the patenting process. The Patent Reform Act, signed into law by the U.S. Congress in April 2007, is an example of how the U.S. political process facilitates company innovation and, therefore, CEO compensation. On the other hand, because political pressure can exacerbate an executive's personal performance risk, making outcomes more unpredictable, "compensation is expected to be decoupled from innovation criteria and financial measures," the authors note.

Country Risk. This refers to the level of uncertainty regarding future economic events at a national level. Despite the current recession, this sort of risk is relatively low in the United States. However, country risk, much like political risk, increases the uncertainty of innovation project outcomes, and CEOs are thus likely to demand a risk premium in order to accept the additional risks, which is reflected in higher compensation packages.

National Culture/Social Idiosyncrasies. This particular dimension of risk threatens innovation, and thus affects compensation schemes. In the academic world, "national culture" can be divided into four main fields of study: power distance, or social stratification; individualism-collectivism, or the desire to promote oneself over the group; masculinity-femininity, or task-oriented versus relation-oriented; and finally, the need for rules and procedures to counter ambiguity and uncertainty. Since North American firms face a culture that values creative development, as well as a culture with low power distance, high individualism and weak uncertainty avoidance, executive salaries benefit as a result.

Non-family CEOs earn more

The paper also evaluates the effects of family ownership on CEO salaries in North American tech firms. Since founding families are present in over a third of Standard and Poor's 500 firms, there would appear to be some correlation between this phenomenon and upper management salaries worth exploring further.

Interestingly, previous studies have shown that CEOs related to founding families tend to have lower salaries, because they are less likely to compete in the global market and they rate job security higher than pay. They also tend to make prudent, rather than risk-laden decisions, regarding R&D projects.

Since R&D is so essential to the high-tech sector, what happens among family-run companies in this field is that they offer higher salaries to non-family CEOs from the global market who would be expected to increase innovation. The result: family member CEOs receive lower salaries than non-family member CEOs.

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As long as CEO salaries continue to hover above the $10 million mark, the public will continue to wonder why the person at the top is taking such a large proportion of the earnings. However, this study at least provides some of the keys to understanding the reasons behind ever-increasing salaries and how compensation is tied to innovation.

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