Can CEO Pay Cuts Generate Stronger Company Performance?

July 20, 2012 -- Scottsdale, AZ -- Last week in this space, I wrote about some new evidence that making incremental progress at work can be more motivational to some employees than money or incentives. This week, different evidence that is more astounding to me—evidence that a pay cut for the chief executive can boost company performance.

Academics Huasheng Gao, Jarrad Harford, and Kai Li have published in the April 2012 issue of the Journal of Corporate Finance the findings of their study of 927 CEOs from 1994-2005. These CEOs experienced compensation cuts of at least 25 percent from the previous year (median reduction of 60 percent in equity comp and 12 percent cut in salary and bonus). The median cut in the sample was US$1.2 million from the prior year—an average decline of about 46 percent.

The academics examined why the pay cuts for these CEOs occurred, and discovered that the boards who had handed down the CEO pay cuts were using this device “as a form of discipline, analogous to outright dismissal, in response to poor firm performance.” In other words, instead of firing the CEO, he or she received a pay cut of about 46 percent.

So how did the firms do after the pay cuts were implemented? That’s what’s astounding to me. According to the article: “…a firm that slashed its CEO’s pay saw its stock go up by 7 percent the following year…similarly, the average return on assets climbed to nearly 12 percent in the three years succeeding a pay cut…”

In the end, the authors conclude from their analysis that pay cuts for CEOs are undeniably associated with performance turnarounds and are an “effective substitute” for outright dismissal (read: firing) of the CEO.

My take on this is this: one certainly has to look hard to see any stories about CEO pay cuts in the mainstream or business press. It’s all about the big pay packages and benefits. I’m frankly a little surprised that these authors were able to find 927 cases during the decade they looked, but nonetheless, they did. Given this data, CEO pay cuts certainly should be viewed as a performance improvement tool for compensation committees everywhere.

There are two other things that I find myself unable to not comment on today:

- From my perspective, easily the biggest story of the week in the total rewards world was about the new 37-year old CEO of Yahoo, who could reportedly earn between $70-$100 million in total compensation in the next five years. The story was big because of two primary elements: 1) she was a long-time Google executive who defected for a company that has seen a revolving door of CEOs in the last few years—not to mention some difficult times, and 2) the fact that she is pregnant. The headlines about “can women really have it all?” were inevitable, and I believe her pregnancy will give this story legs (unintentional pun) until and through the baby’s arrival and first few months. Ms. Mayer is going to be under a microscope for the next year for a variety of reasons. I hope she is successful.

- Finally, the other big story of the week was the horrific scent that unfolded in Aurora Colorado. We are all thinking about those lost and injured and the families and loved ones of those lost and injured.
Gender Pay Difference

A new study by a couple of academics can be added to the pile of literature about gender pay differences.

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