

CEO Pay in Orange County

OC CORPORATE GOVERNANCE BULLETIN // OCTOBER 2014 // Vol. 1 Issue 2





Note from the Director

About CCRG

The Center for Corporate Reporting and Governance (CCRG) is the premier resource for financial reporting and corporate governance in Orange County, California. Part of the Mihaylo College of Business and Economics at California State University, Fullerton, CCRG was created in 2003 to address corporate reporting and governance issues facing companies and their auditors in the changing financial environment. CCRG advances corporate reporting and governance practices through education, research and collaboration with the business community and regulators.

For more information, visit business.fullerton.edu/centers/ccrg/

The highly anticipated analyses of CEO compensation for Orange County companies are finally here! CEO pay continues to be a burning issue for boards, shareholder activists, the media and other interest groups. Say on Pay was the rallying cry for shareholders in the last few years. This year the focus is back on where it should be: rigor of performance metrics and terms of incentive pay.

Over the past few months, CCRG's research staff, Nick Jenkins and Jesse Ben-Ron, have painstakingly collected CEO pay and performance data for OC companies for the 2014 proxy season. Their effort in no small measure has led to the launch of the Center's first research bulletin on CEO pay. CCRG

intends to provide annual updates on this same time-table to attendees at our CEO compensation conference co-hosted with the *Forum for Corporate Directors (FCD)*. This year's conference, on October 16th at the Pacific Club, will be our Fifth Conference on CEO pay and is a shining example of a successful collaboration of Mihaylo academia with industry.

In other news, in August, CCRG concluded its stock options webinars in which Mihaylo faculty taught collaboratively with experts from PwC and E&Y. By the time this bulletin is printed, CCRG will have concluded its 13th Annual SEC conference at the Hotel Irvine. This year's conference theme was on Global Megatrends that will be shaping how companies do business in the future. As of this writing, the conference is nearly sold out with 450 registered attendees! Credit goes to CCRG's board for putting this outstanding program together.

The CSUF Center for Corporate Reporting and Governance is emerging strongly as the thought leader for corporate financial reporting and governance matters in Orange County. I invite you to visit business.fullerton.edu/centers/ccrg and hope to see you at one of our upcoming events.

Vivek Mande, Ph.D.
Director, Center for Corporate Reporting & Governance
White Nelson Diehl Evans Professor of Accounting

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Executive Summary



Companies have begun to phase out stock options, replacing them with stock awards which have steadily grown to become the largest component of CEO equity pay.

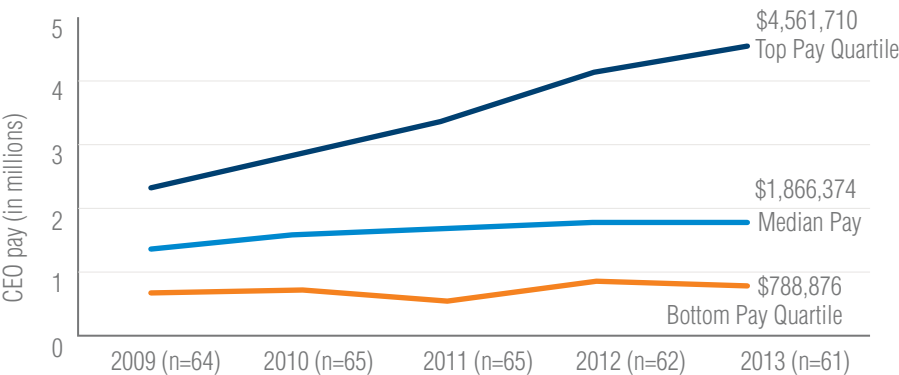
New tax, accounting and disclosure regulations have brought a renewed focus on executive pay. We compare recent trends in CEO pay and components of CEO pay in Orange County (OC) companies with those in S&P 1500 companies. We also discuss performance measures used in determining CEO pay and the relationship between CEO pay and shareholder value creation. Our report is based on CEO pay data collected on 56 OC companies from 2009 to 2013. Our key findings are:

- While median CEO pay in OC increased from 2009 to 2013, the largest pay increase was received by CEOs in the top pay quartile.
- CEOs in pharmaceutical and bio-tech industries received the highest pay.
- Company size explained over half of the variation in OC CEO pay. CEOs in OC companies reporting more than \$ 5 billion in revenues earned more than double the pay of CEOs in companies reporting revenues between \$ 1 billion and \$ 5 billion.
- Companies have begun to phase out stock options, replacing them with stock awards which have steadily grown to become the largest component of CEO equity pay.
- The performance measures most used for providing short term incentives to OC CEOs were: revenues and individual goals. EPS and operating income were the next two popular metrics. However, explicit disclosure of performance measures used in CEO short-term incentive plans was lacking in many companies.
- With regard to long term incentives, relative TSR and operating income were the most popularly used metrics.
- Overall, the link between absolute CEO pay and total shareholder return was positive, albeit weak. This weak association was also found for S&P 1500 companies.

1. Trends in CEO Pay

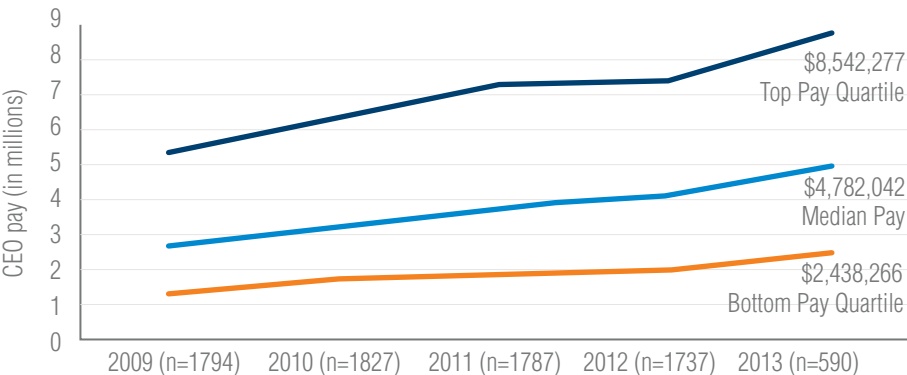
Over the past five years, OC CEOs have seen steady increases in their pay.¹ In 2013, the median CEO pay in the top pay quartile was 96% higher than the median CEO pay in the same quartile in 2009. In comparison, the bottom 25% of CEOs saw only modest pay increases between 2009 and 2013. However, even for this group, median CEO pay was approximately 15 % higher in 2013 than in 2009. The overall median OC CEO pay, which in 2013 was \$1,866,374, has also steadily increased every year.²

CEO Pay in OC Companies



The trend in CEO pay for S&P 1500 companies is similar to that for OC companies, with a few exceptions.³ Nation-wide, CEOs in the bottom quartile saw the largest percentage gain in median pay (87%) between 2009 and 2013. The percentage increase in median CEO pay in the S&P 1500 companies (approximately 80%) over this period was also greater compared to that for OC companies (approximately 37%). In 2013, year over year median CEO pay increase in the S&P 1500 firms was 16 % (\$4.09 million to \$4.78 million), while in OC companies, the rate of increase in median pay was 4.2% (\$1.79 million to \$1.87 million).

CEO Pay in S&P 1500 Companies



¹ Our methodology is as follows. We obtained a list of OC publicly traded companies from the Orange County Business Journal (OCBJ). We then obtained OC CEO pay data primarily from ExecComp Analytics, a database maintained by Institutional Shareholder Services (ISS). For OC firms that did not have CEO pay data on ISS databases, we collected the pay data from proxy statements on the SEC's Edgar system. CEO pay data on S&P 1500 companies was collected from S&P's ExecuComp database. There are certain cautionary statements that accompany our methodology. Because we included all data points on CEO pay, CEO turnover and one-time pay arrangements with CEOs have the potential to cause distortions in our analyses. In 2013, for example, there were five companies that experienced CEO turnover, giving us 61 CEO pay data points for 56 OC companies. Second, on average, OC companies are smaller than S&P 1500 companies and are concentrated in certain industries. This reduces comparability of OC pay data with S&P 1500 pay data. Third, we acknowledge that there are alternative pay metrics that can be used to evaluate CEOs. We did not, for example, analyze realizable pay in this issue.

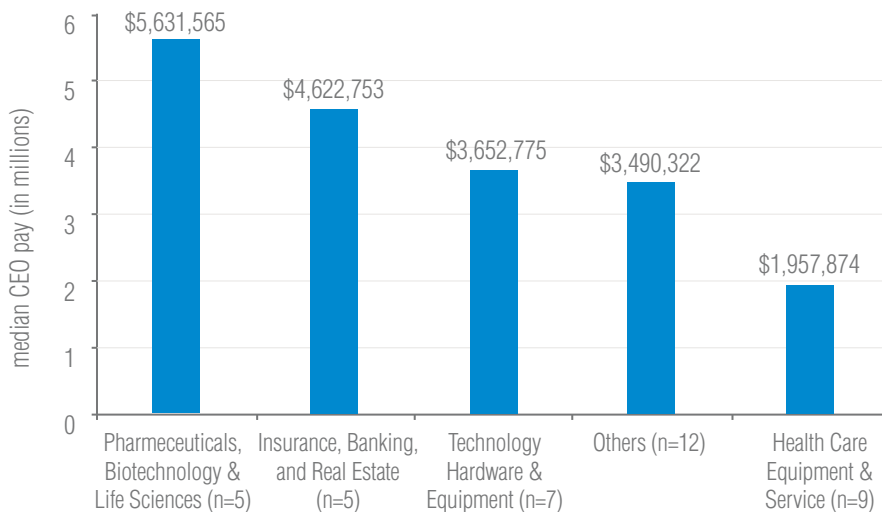
² We used the median value of CEO pay instead of mean value because outliers have a smaller distorting effect on the median than the mean.

³ As of this writing, CEO compensation data was not available for all of the S&P 1500 companies for the year 2013.

2. CEO Pay by Industry

We classified OC companies into five groups based on their industry membership provided by ISS.⁴ In 2013, the median CEO pay in the Pharmaceuticals, Biotechnology & Life Sciences industry was the highest, followed by median pay in Insurance, Banking, and the Real Estate industry group.

CEO Pay in OC by Industry (N=38)

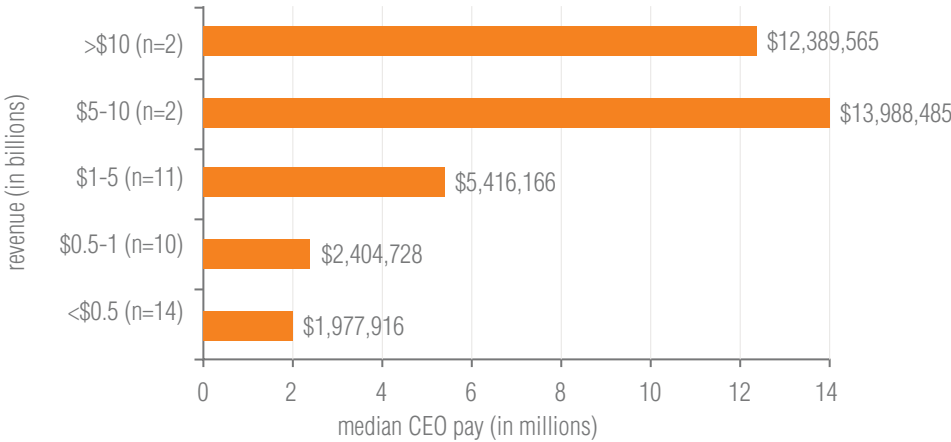


⁴ The industry analysis of OC companies was based on 38 OC companies for which data was available on ISS' ExecComp Analytics databases. The "other" category included 12 OC firms belonging to a wide range of industries such as Materials and Consumer Products.

3. CEO Pay and Company Size

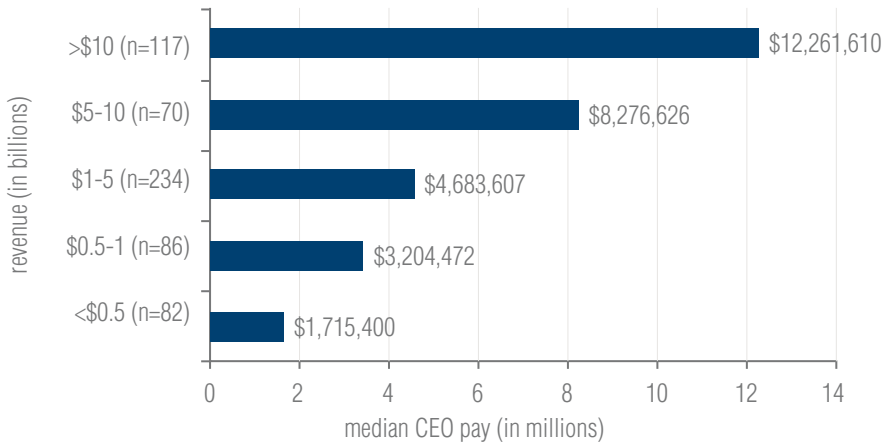
We measured company size using annual revenues. In 2013, over 60% of OC companies had revenues of less than \$ 1 billion. As company size is the most important determinant of CEO pay, not surprisingly, we found that CEOs of larger companies were paid more than CEOs of smaller companies.⁵ Companies with over \$5 billion in revenue paid their CEOs about 120 percent more than the next size-group of companies that reported revenues between \$1 and \$5 billion.

CEO Pay in OC by Company Size (N=38)



A positive relationship of CEO pay with revenues was also found in the S&P 1500 companies. Compared to OC firms, only 28% of S&P 1500 firms had revenues of less than \$1 billion. Except for the revenue category, [\$ 0.5 billion, \$1 billion], median CEO pay in OC companies was higher than median pay in S&P 1500 companies in each size group.

CEO Pay in S&P 1500 by Company Size (N=589)



Company size explained 52% of the variation in CEO pay.

⁵ The relationship between pay and sales was tested using a regression model. Company size explained 52% of the variation in CEO pay. Our estimated model is: Total pay = 2,875,934 + 0.0009 * Sales Revenue; R-Squared is 0.52.

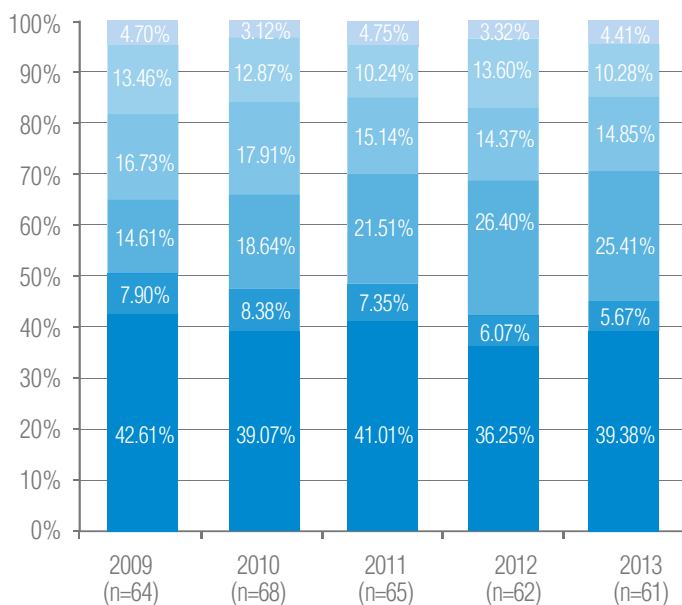
4. CEO Pay Components

CEO pay is made up of salary, bonuses, stock awards, stock options, non-equity long term incentives, and other compensation such as pension and perquisites. In OC companies, salary comprised the largest component of CEO pay. Salary was also a bigger proportion of CEO pay than in the S&P 1500 companies. Replacing stock options, stock awards have become the second largest component of OC CEO pay.⁶ It is worth noting that stock awards represented a larger component of CEO pay in the S&P 1500 than in OC companies.

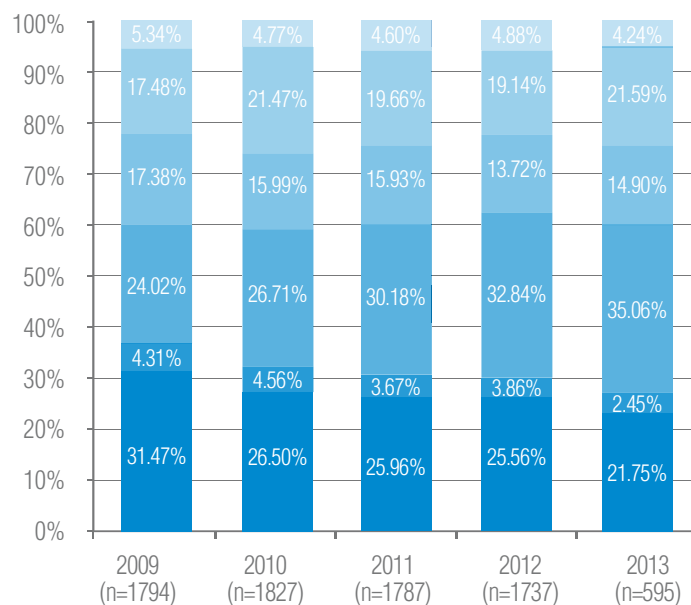


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Components of CEO Pay
in OC Companies



Components of CEO Pay
in S&P 1500 Companies



Other
Non-equity Incentives
Option Awards
Stock Awards
Bonus
Salary

Replacing stock options, stock awards have become the second largest component of OC CEO pay.

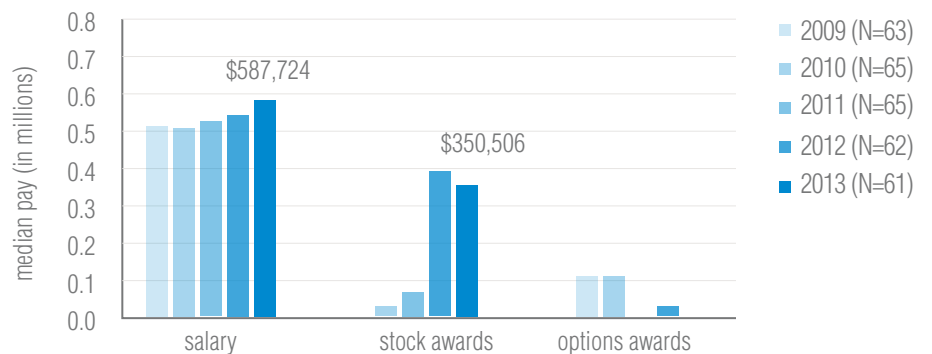
⁶ For each company in our sample in a given year, we first divided each pay component by total CEO compensation. This provided us with the percentage of total pay represented by a pay component for a given CEO for a given year. For each pay component, we then took the mean of these percentages across all companies in each year. These percentages, therefore, do not add up to 100%.



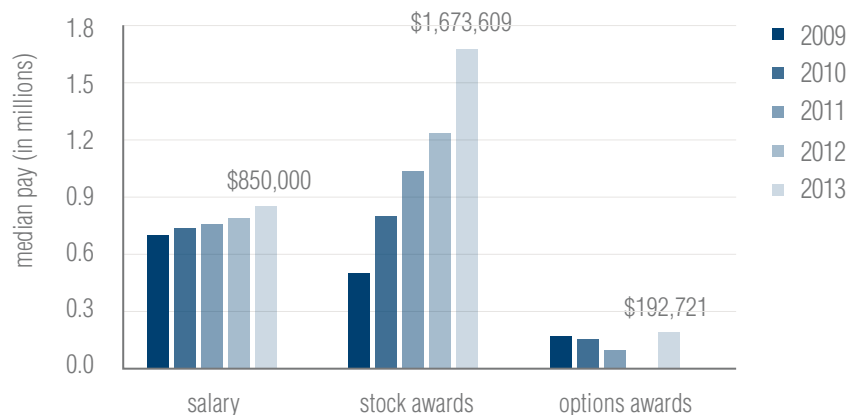
Similar to S&P 1500 companies, the median value of option awards was smaller and showed a general decreasing trend in OC companies.

The next two graphs provide additional details on trends in CEO pay components. Median CEO salary has been increasing each year from 2009 to 2013. However, the most significant increase is seen with stock awards. Similar to S&P 1500 companies, the median value of option awards was smaller and showed a general decreasing trend in OC companies.⁷

Median Pay by Component in OC Companies



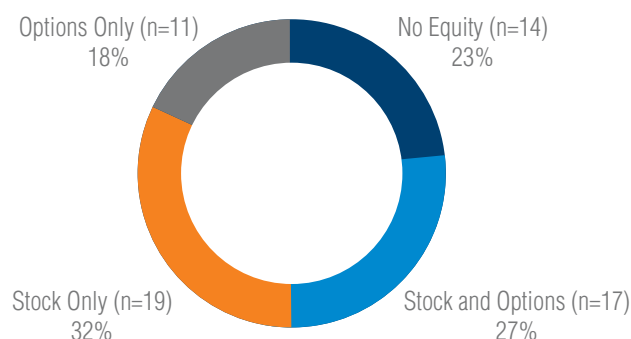
Median of Pay Components in S&P 1500 Companies



⁷ The median value of options in OC Companies is zero in 2013 because a majority did not award any options.

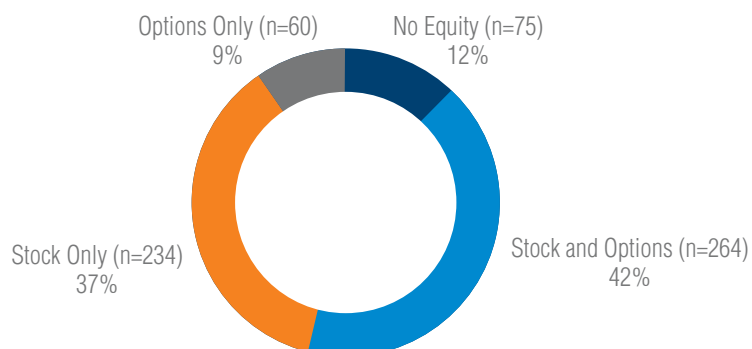
Turning to equity pay, we found that 23% of OC companies did not award any equity compensation in 2013 while 18% of companies granted equity pay consisting of only stock options.⁸

Components of CEO Equity Pay in OC Companies (N=61)



In comparison, about 79% of S&P 1500 companies issued either just stock awards or stock awards along with options. Only 12% of S&P 1500 companies did not grant equity pay compared to 23% of OC companies.

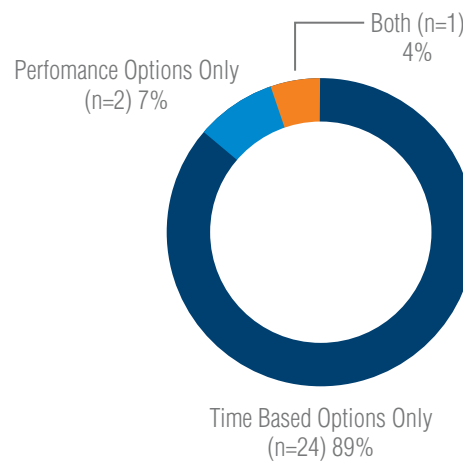
Components of CEO Equity Pay in S&P 1500 Companies (N=633)



⁸ In separate analyses (not shown), we found that the Health Care Equipment and Services industry ranked at the top as far as granting only options as equity pay to CEOs. Additionally, 22% of companies in this industry did not award any equity pay to their CEOs. In comparison, all of the firms in the Pharmaceuticals, Biotechnology, and Life Sciences; Technology, Hardware, and Equipment and Insurance; Banking, and Real Estate industries granted equity compensation to their CEOs. Firms in the Technology, Hardware, and Equipment did not grant options alone as equity pay. Firms with less than \$500 million revenue tended to grant options only as equity pay. All firms with revenues greater than \$1 billion gave their CEOs equity pay, whereas 29% of companies with revenues of less than \$1 billion did not give equity pay.

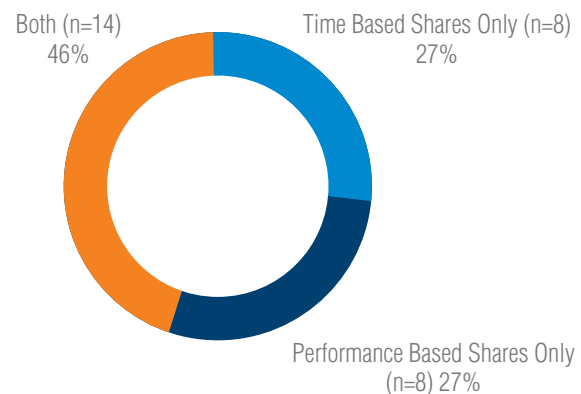
Among the OC firms that granted shares to their CEOs, most firms awarded performance shares (73%), while only 11% of firms granting options awarded performance options.⁹

Time and Performance Based Options Issued by OC Companies (N=27)



Among the OC firms that granted shares to their CEOs, most firms awarded performance shares (73%), while only 11% of firms granting options awarded performance options.

Time and Performance Based Shares Issued by OC Companies (N=30)

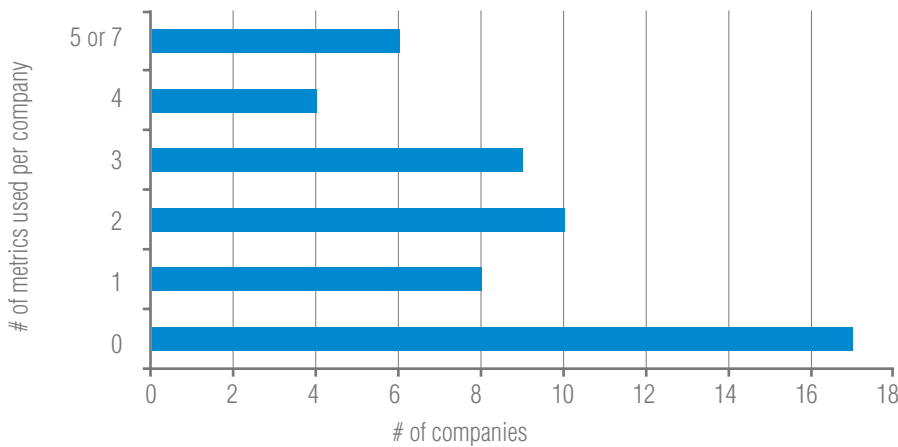


⁹ This data is only based on ISS information. The number of observations, therefore, is not the same as what was used in the preceding analyses.

5. Performance Measures

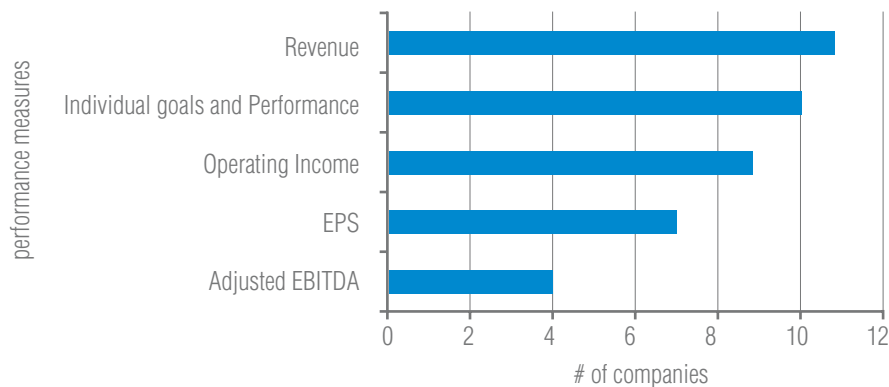
We found that a significant number of OC companies either did not have or did not choose to disclose performance metrics used in aligning their CEOs' pay with performance (approximately 32%). When companies did disclose short-term performance measures, we found that they generally tended to use one to three short-term performance measures.

Number of Short Term Performance Measures Used by OC Companies



In total, we counted 55 different metrics being used to provide CEOs with short-term incentives. For purposes of brevity, we only graphed a performance measure if it was used by at least four OC companies. The chart below shows the frequency with which these performance measures were used. We found that revenue was the most used performance measure, followed by individual performance.

Short Term Performance Measures Used by OC Companies



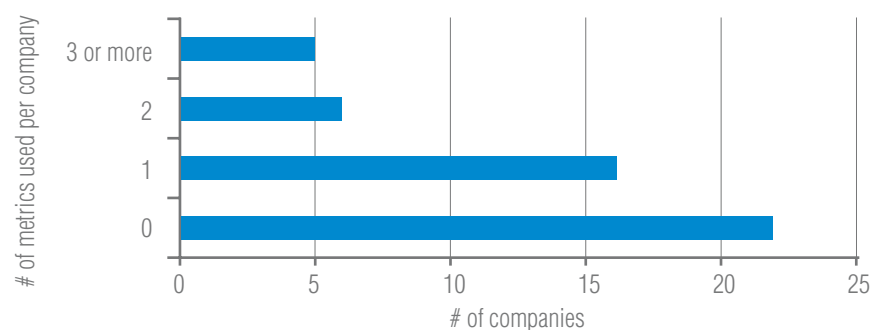
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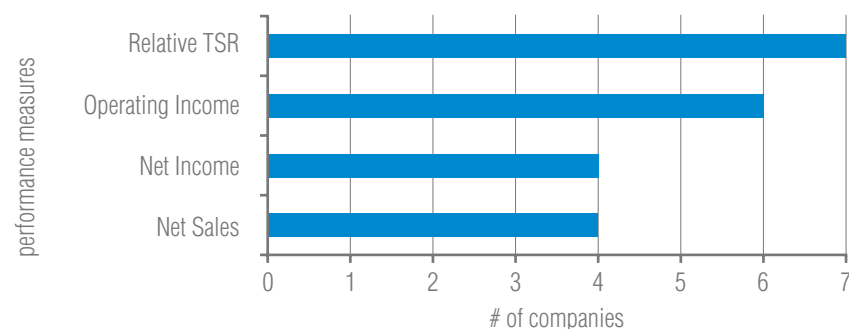
The most frequently used metric for long term incentive was relative TSR, followed by operating income.

With regard to incentivizing CEOs for long term performance, we identified over 40 different metrics used by OC companies. About half of OC companies did not disclose or did not use any performance measures for determining long term incentives. For companies that did disclose, most used only one performance metric. The most frequently used metric for long term incentive was relative TSR, followed by operating income.

Number of Long Term Performance Measures Used by OC Companies



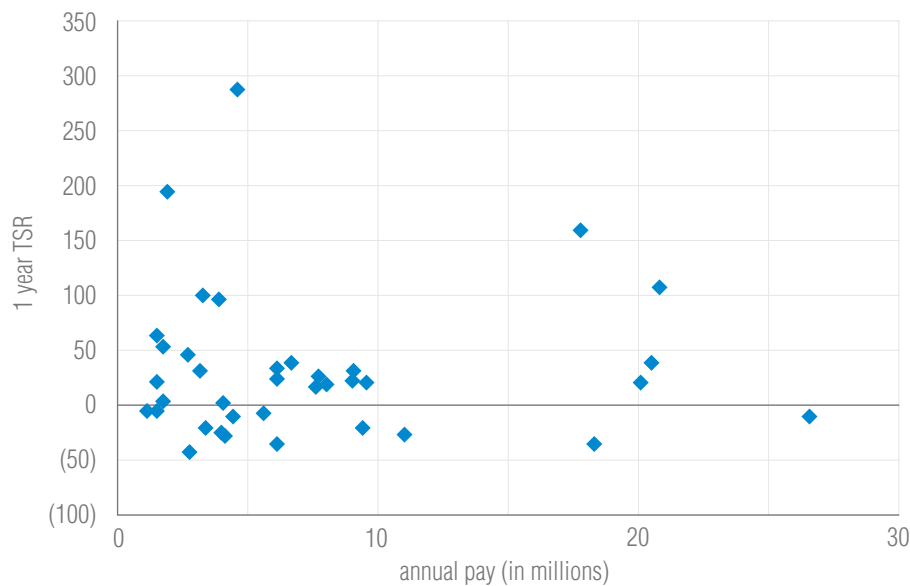
Long-Term Performance Measures For OC Companies



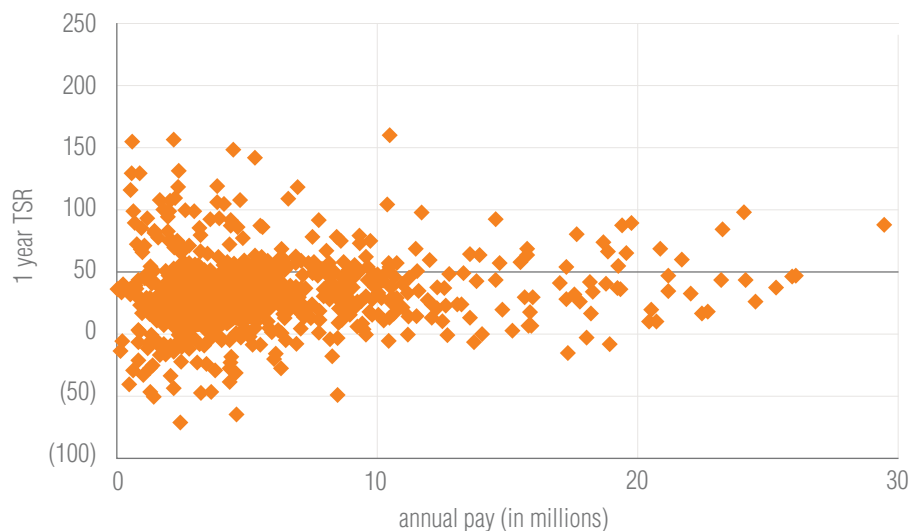
6. Pay and Performance

We plotted annual CEO pay against annual total shareholder return (TSR) for 2013 and found a weak linear relationship.¹⁰ While shareholders expect higher pay to be associated with higher performance, we did not find a strong relation for OC and S&P 1500 companies.¹¹

Annual Pay and One Year TSR for OC Companies (N=38)



Annual Pay and One Year TSR for S&P 1500 Companies (N=594)



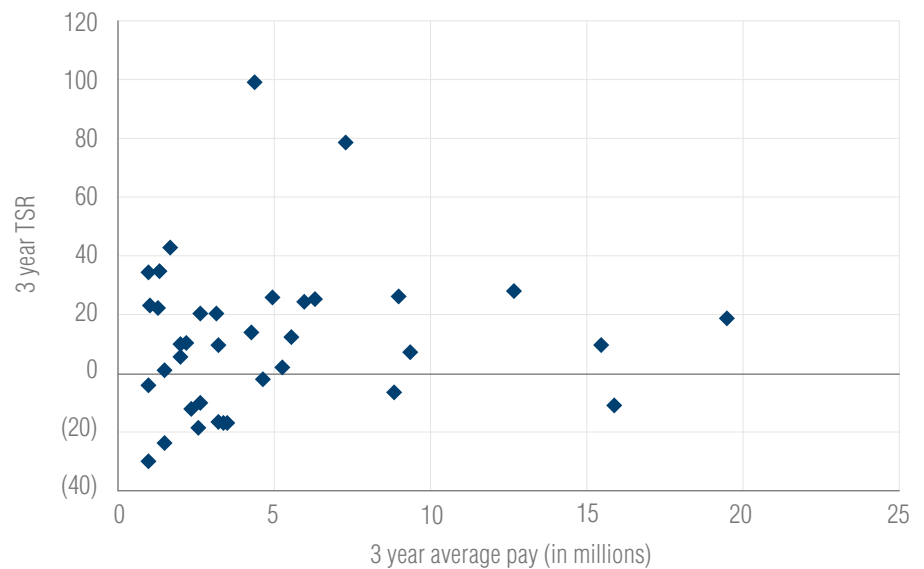
While shareholders expect higher pay to be associated with higher performance, we did not find a strong relation for OC and S&P 1500 companies.

¹⁰We conducted this analysis using 38 companies for which ISS data was available. ISS databases provided both CEO pay and shareholder return.

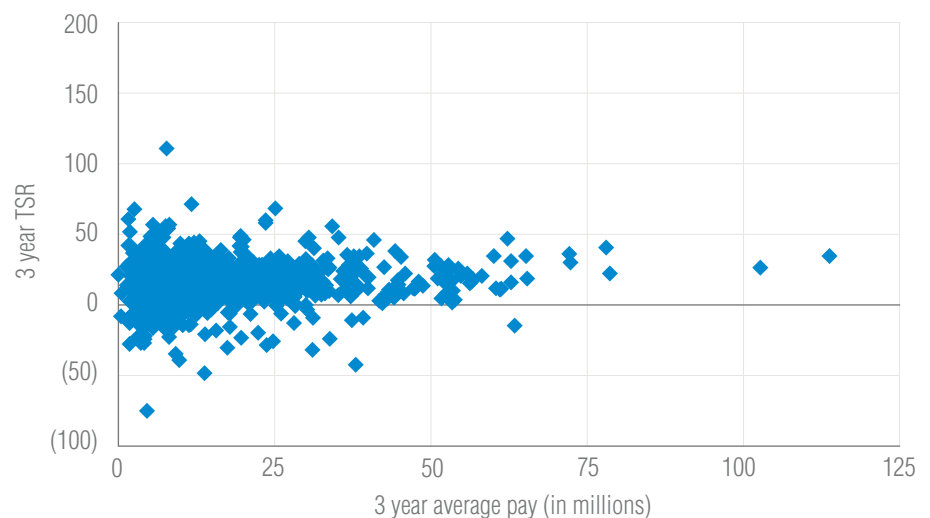
¹¹The effect of total pay on annual total shareholder return (TSR1) was tested in a regression model. We found the following: $TSR1 = -0.6686 + 0.0598 * \log$ of total pay; $R\text{-squared}=0.01$. The result indicates that total pay is not an important determinant of shareholder returns.

We also plotted the three-year average CEO pay with three-year shareholder return for both OC and S&P 1500 companies. The linear relationship improved but remained weak in both groups of companies.¹²

Three Year Average Pay and Three Year TSR for OC Companies (N=38)



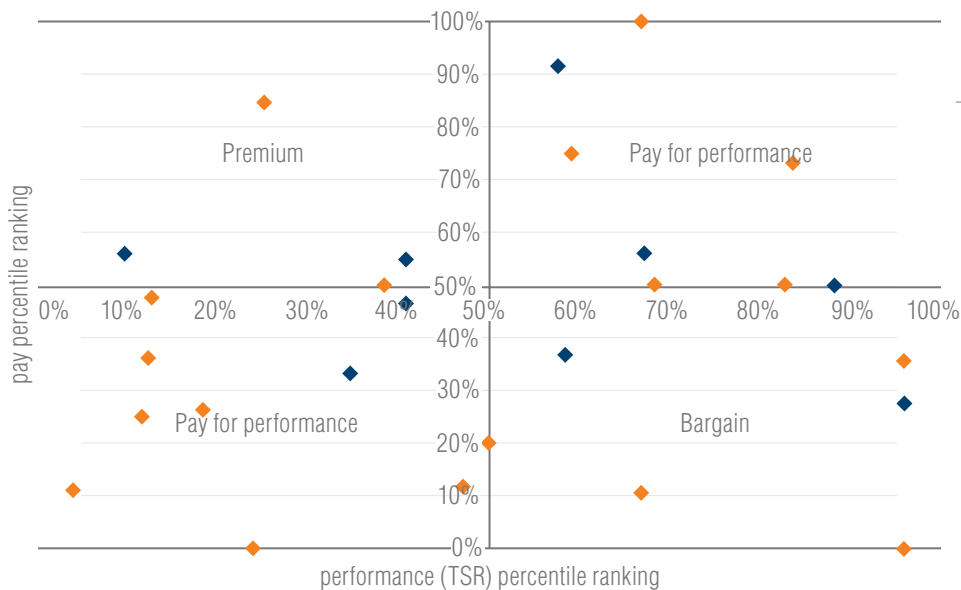
Three Year Total Pay and Three Year TSR for S&P 1500 Companies (N=584)



¹² When we used three-year data in our regression of CEO pay on shareholder returns, we continued to find an insignificant relationship between these variables. The R-squared improves marginally to 2%.

Finally, we examined the relationship between relative pay and relative performance. We compared each CEO's pay and performance relative to their peers. We assigned a pay percentile ranking and a TSR percentile ranking based on how an OC firm ranked relative to its peers as defined by ISS.¹³ The graph shows that the relationship between pay and performance is still weak.¹⁴ We did not find a concentration of companies by industry or size in any of the quadrants shown below.

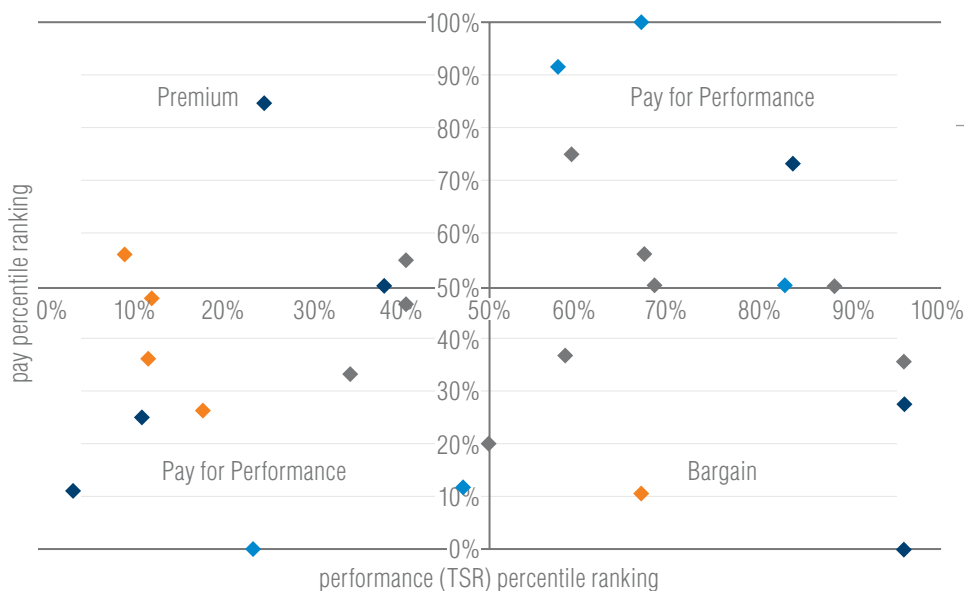
Performance Ranking vs Pay Ranking (N=27)



The graph shows that the relationship between pay and performance is still weak.

◆ Denotes companies with less than one billion in revenue.

Performance Ranking vs Pay Ranking (N=27)



◆ Pharmaceuticals, Biotechnology & Life Sciences
◆ Health Care Equipment & Service
◆ Technology Hardware & Equipment
◆ Other

¹³ This chart used 2012 data because as of this writing ISS peer firm data for 2013 was not ready for analysis. ISS Peer data was only available for 27 OC firms.

¹⁴ Our regressions of relative pay on relative shareholder return showed an insignificant relationship between the variables and a low R-squared.

7. Conclusion

In our analyses of CEO pay in Orange County (OC), we found some interesting trends:

- Average CEO pay has steadily increased over the last five years.
- CEO pay in the highest quartile experienced the highest pay increase.
- CEO pay in S&P 1500 companies has risen at a faster rate than CEO pay in OC companies.
- CEOs in OC experienced the lowest pay increase in 2013 during the five years examined.

Industry by industry analyses showed that OC CEOs in the Pharmaceutical and Bio-tech industries brought home the highest pay, followed by CEOs in Insurance, Banking, and Real estate. The popularity of stock options as an incentive mechanism has been declining while that of stock awards has been increasing in both OC and S&P 1500 companies.

As for short-term performance measures, revenue and individual goals were the most popular choices among OC firms, although a large percentage did not disclose measures used, if any. The most frequently used long term performance metrics were relative TSR and operating income. Finally, the link between absolute CEO pay and total shareholders' return was tenuous at best in both OC and S&P 1500 companies.

Biography of Authors

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List of OC Companies

No. Company Name

1	Acacia Research Corp.	35	Newport Corp.
2	Allergan Inc.	36	Pacific Mercantile Bancorp
3	Alliance HealthCare Services Inc.	37	Pacific Premier Bancorp Inc.
4	American Vanguard Corp.	38	Pacific Sunwear of California Inc.
5	Autobytel Inc.	39	Peregrine Pharmaceuticals Inc.
6	Avanir Pharmaceuticals Inc.	40	Pro-Dex Inc.
7	BJ's Restaurants Inc.	41	Qlogic Corp.
8	Bridgford Foods Corp.	42	Quality Systems Inc.
9	Broadcom Corp	43	Quantum Fuel Systems
10	California First National Bancorp	44	Questcor Pharmaceuticals Inc.
11	Clean Energy Fuels Corp.	45	Quiksilver Inc.
12	Collectors Universe Inc.	46	Sabra Health Care REIT Inc.
13	Comarco Inc.	47	Skilled Healthcare Group Inc.
14	Consumer Portfolio Services Inc.	48	Smith Micro Software Inc.
15	CoreLogic Inc.	49	Spectrum Pharmaceuticals Inc.
16	Corinthian Colleges Inc.	50	Standard Pacific Corp.
17	Corvel Corp.	51	Sunstone Hotel Investors Inc.
18	Edwards Lifesciences Corp.	52	TigerLogic Corp.
19	Emulex Corp.	53	TTM Technologies Inc.
20	Endologix Inc.	54	Universal Electronics Inc.
21	Ensign Group Inc.	55	Western Digital Corp.
22	First American Financial Corp.	56	Willdan Group Inc.
23	ICU Medical Inc.		
24	Identive Group Inc.		
25	Impac Mortgage Holdings Inc.		
26	Ingram Micro Inc.		
27	Iteris.com		
28	Kaiser Aluminum Corp.		
29	Lantronix Inc.		
30	Local.com Corp.		
31	Masimo Corp.		
32	Microsemi Corp.		
33	Multi-Fineline Electronix Inc.		
34	Netlist Inc.		



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The course, Employee Stock Options, will be offered in two parts in Spring 2015 via Webcast and on the CSUF campus in Fullerton. Part I will examine the accounting for stock options from a GAAP perspective, while Part II will focus on tax issues associated with stock options. The registration fee is \$195 per course or \$350 for both courses.



Employee Stock Options, Part I (4 CPE Units): Accounting under FASB ASC Topic 718, **\$195**

Employee Stock Options, Part II (2 CPE Units): Tax Accounting & Tax Issues, **\$195**

Employee Stock Options, Parts I & II (6 CPE Units): **\$350 (Save \$40!)**

For program level, prerequisites, policies and detailed information about the courses or to register, please visit the CPE Training Academy website, business.fullerton.edu/centers/ccrg/USGAAP_Training/courses.htm or contact CCRG at **657-278-4414** or ccrg@fullerton.edu.

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