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Compensation goals and firm performance

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ABSTRACT

Using a large data set of performance goals employed in executive incentive contracts, we find that a disproportionately large number of firms exceed their goals by a small margin as compared to the number that fall short of the goal by a similar margin. This asymmetry is particularly acute for earnings goals, when compensation is contingent on a single goal, when the pay-performance relationship around the goal is concave-shaped, and for grants with non-equity-based payouts. Firms that exceed their compensation target by a small margin are more likely to beat the target the next period and CEOs of firms that miss their targets are more likely to experience a forced turnover. Firms that just exceed their Earnings Per Share (EPS) goals have higher abnormal accruals and lower Research and Development (R&D) expenditures, and firms that just exceed their profit goals have lower Selling, General and Administrative (SG&A) expenditures. Overall, our results highlight some of the costs of linking managerial compensation to specific compensation targets.

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1. Introduction

In their ongoing effort to link managerial pay to performance, firms are increasingly tying non-equity and equity grants to achieving explicit performance goals. Institutional investors and large shareholders like Warren Buffett have been major proponents of assessing management against specific performance goals. A typical equity or non-equity grant linked to firm performance identifies threshold, target, and maximum values for one or more accounting, or stock price-based metrics. The payout from the grant or the vesting schedule of the grant is then tied to the firm achieving these particular performance goals. For example, a manager may receive no payout if performance is below the threshold and her payout may increase as performance exceeds the threshold. The slope of the pay-performance relationship (PPR) may also change at the target and the

maximum value, with discontinuous slope changes generating a “kink” in the PPR.¹ In this paper, we use a comprehensive data set containing information on the performance goals employed in pay contracts to highlight some of the costs of this popular pay feature.

Rewarding managers for achieving explicit performance goals certainly has a bright side. It makes pay more transparent and offers strong incentives, especially when the goal is challenging. On the other hand, identifying explicit performance goals and having “jumps and kinks” in the PPR at the goals may also have a dark side. If there is a jump in managerial pay for achieving a performance goal, and if actual performance is close to but short of the goal, managers may be tempted to take actions – with possible negative long-term consequences – to push reported performance to (or past) the goal. In other words, managerial myopia may be exacerbated around “jump points” in the

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PPR. The effect of kinks on managerial behavior is more nuanced. If the kink is concave, it may reduce the manager's incentives to improve firm performance much beyond the kink. On the other hand if the kink is convex, it will not only incentivize managers to push performance beyond the kink, but may also affect their incentives to take risk.

Explicit target performance goals may also influence reported firm performance for reasons not directly related to the payout from the grant. Managers may not want to exceed the target performance by a large amount if better current period performance results in higher targets in subsequent periods ("target ratcheting effect"). If the board focuses on the target as the expected performance and punishes underperformance, say by firing the CEO, then CEOs may want to achieve the target performance and not fall short. We call this the "forced turnover effect." We use our data to understand how goals in the incentive contracts influence reported performance. Specifically, we study the distribution of reported performance around the incentive goals and test to see if performance clusters around the goals. We also conduct tests to explore the possible reasons for such clustering.

If firms manage reported accounting performance to either beat the goal or to not exceed the goal by a large amount, then the actual performance of a disproportionate number of firms will just exceed the goal as compared to the number that just miss the goal. In other words, the distribution of reported performance will exhibit a discontinuity around the goal (Burgstahler and Dichev, 1997; Bollen and Pool, 2009). McCrary (2008) develops a test to identify if a probability density has a statistically significant discontinuity at a given point. We employ this methodology, along with the tests in Bollen and Pool (2009) and additional bootstrapping techniques to test for the presence of discontinuities.²

We obtain data on performance goals from Incentive Lab (IL) who in turn obtain it from firms' proxy statements. We have information on all the cash, stock, and option grants awarded to a top five, highest paid executives of the 750 largest firms by market capitalization over the time period 1998–2012. We have information on the metric(s) the grant is tied to, the nature of the relationship, i.e., whether the payout or vesting schedule is tied to the metric(s), and the nature (absolute versus relative) and specific value of the performance goal. Given our interest to detect performance management, for most of the paper we focus on grants to the firm's CEO linked to an absolute accounting-based metric that we can match with actual performance as reported in Compustat. This limits the grants to those that are tied to the level or the growth of one of the following metrics: Earnings, EPS, Sales,

² To the extent managerial pay discretely increases at the goal, a discontinuity in reported performance at the goal may also be consistent with managers working "very hard" when actual performance is close to the goal. We call this the "effort channel." Since we don't observe managerial effort, it is very difficult to distinguish the effort channel from the performance management channel. We compare firms that just beat and just miss benchmarks on a number of observable dimensions to characterize the firms whose performance clusters just above the goal. These tests help us understand the underlying mechanism at work.

Earnings Before Interest and Tax (EBIT), Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), Operating income, and Funds From Operations (FFO). This results in a sample of 5,810 grants awarded by 974 firms.³ Among the accounting metrics employed, EPS is the most popular with around 46% of the grants linked to an EPS goal. Cash and stock are the most popular modes of payout for the grants in our sample, with over 72% (28%) of the grants involving some cash (stock) payout.

We begin our empirical analysis by comparing the target performance in the pay contract to the firm's reported performance. We focus much of our analysis on the target because not only do we have information about the target for most grants, but firm performance often clusters around the target and this increases the power of our tests of discontinuity in the underlying density. We construct a variable, *Actual less target* to help us identify clustering of performance at the goal. *Actual less target* is the difference between actual performance as reported in Compustat and the target goal as identified in the pay contract. We construct this separately for EPS, sales, and profit goals and normalize each by its standard deviation before combining into a single variable. We normalize by standard deviation to adjust for possible noise in our matching of actual performance and compensation goals. We find that the density of *actual less target* has a significant discontinuity at zero. A disproportionately large number of firms exceed the performance target by a small amount as compared to the number of firms that fail to meet the performance target by a small amount. These results are confirmed by the two other methods we employ to test for discontinuity, namely, the bootstrapping test and the regression-based test.

When we focus on the individual performance measures, the (McCrary, 2008) test shows a statistically significant discontinuity only for EPS goals. The discontinuity around profit and sales goals is not statistically significant. In contrast, our bootstrapping exercise finds a discontinuity for all three measures.

Next, we study the relationship between threshold and reported performance. Here again, we find that firms are significantly more likely to beat the threshold by a small margin as compared to just miss the threshold by a small margin. Since there usually is a jump in pay at the threshold performance for most of the grants in our sample, the clustering of performance around the threshold is less of a surprise.

We perform a number of cross-sectional tests to better understand the reasons for the observed discontinuity. Many plans include multiple metrics and since metrics are generally positively correlated, it will be difficult for executives to "just barely beat" the target for all metrics simultaneously. For example, if a CEO aims to meet an EPS goal by a small margin, she might inadvertently beat the profit target by a wide margin. Therefore, if performance clusters at the target because of performance management, then we should see more clustering for grants contingent on a

³ We also design placebo tests on grants linked to relative performance goals, for which we include grants tied to relative stock and accounting performance.

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