The Quarterly Review of Economics and Finance 57 (2015) 191–206

Contents lists available at ScienceDirect

The Quarterly Review of Economics and Finance

journal homepage: www.elsevier.com/locate/qref

Dynamics of CEO compensation: Old is gold

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ARTICLE INFO

Article history:
Received 24 January 2014
Received in revised form 4 November 2014
Accepted 10 January 2015
Available online 22 January 2015

Keywords:
Corporate governance
Agency problems
SOX
CEO age
CEO compensation

JEL classification:
G30
G34
G39
J20
J21
J23
J24
J33

ABSTRACT

There is an ongoing debate regarding the hiring and compensation of younger versus older employees. In this paper, we examine this question for Chief Executive Officers (CEOs) in the context of the Sarbanes–Oxley Act (SOX) of 2002. We argue that the increased complexities in the post-SOX era (regulatory, technological, and the ever-changing business environment) have forced corporate boards to incentivize top executives for the increased burden. We contend that older CEOs are perceived as more reliable, efficient, and trustworthy (to fulfill the regulatory requirements demanded by SOX) than their younger counterparts. Consistent with our contention, we find that the total compensation of CEOs of U.S. firms has increased significantly for older CEOs as compared to their younger counterparts after the introduction of SOX. Our results are robust to sophisticated econometric techniques and also consistent with the logic that in order to motivate older CEOs (who would have raised substantial personal wealth over time) to keep working rather than retiring or moving to a competitor, their compensation package must be highly competitive.

1. Introduction

The CEO plays an important role in the efficient performance of the firm, while also maneuvering a course for the firm's future. The CEO functions like a rudder of a boat and provides direction to the firm. The stakeholders of the firm place their confidence in the CEO and expect her to consider their welfare in the performance of her duties. As such, every firm should strive to recruit the best possible CEO to cater to the needs of shareholders, employees, consumers, and regulators, all of which are stakeholders. Thus, the labor market for CEOs should value certain CEOs more than others based on a variety of parameters.

One of the most important discussions related to CEOs is their age[1]. Yim (2013) provides evidence that firms with older CEOs (older by 20 years) are 30% less likely to announce an acquisition. Yim (2013) notes that younger CEOs who expect to obtain greater financial benefits are more motivated to pursue acquisitions and these acquisitions can lessen the value of the firm. These findings are not a result of a reduction in overconfidence with age. This study clearly indicates that CEO age is an important variable to consider in the corporate setting of U.S. firms.

Recent upsurges in firms led by young CEOs in the U.S. have prompted the financial press to focus on the age of these CEOs[2].

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[1] See "Does Age Matter When You're a CEO?" by Del Jones, *USA Today*, November 9, 2008.
[2] See "Young CEOs: Are They Up to the Job?" by Spencer E. Ante and Joann S. Lublin, *The Wall Street Journal*, February 7, 2012.

http://dx.doi.org/10.1016/j.qref.2015.01.007
1062-9769/

The debate typically pits the benefits of creativity and familiarity with emerging technologies found in young CEOs against the need for disciplined decision making and experience dealing with difficult scenarios found in older CEOs. In a Wall Street Journal article, Mr. Wadhwa (a technology entrepreneur) proposes that older CEOs may be better and more successful in technology firms as "Age provides a distinct advantage."

These articles in the media compare the choice between younger versus older CEOs based on their enthusiasm, effectiveness, and compensation. A key question that these stories raise is whether older CEOs are more desirable than their younger counterparts, ceteris paribus.[3] In contrast with the general impression that CEOs are too old to manage businesses in their 60s or early 70s, it is fascinating to note that many companies opt for older CEOs.[4] Along the same line of reasoning, in 38 U.S. presidential elections since 1856, older candidates have won 24 times, implying that the U.S. population, in general, doesn't view age as a weakness when selecting a leader. If older CEOs are more desirable than younger CEOs due to certain qualities related to their age, then they would be better compensated than younger CEOs in business situations favoring older CEOs.

This is an important question especially in light of the regulatory requirements brought about by regulations like the Sarbanes Oxley Act of 2002 (SOX). SOX promotes ethical behavior and transparency in business practices for public U.S. firms. SOX states that each CEO and CFO must have a complete understanding of all SEC standards of compliance and their reporting requirements. They are also held accountable for their corporation's reporting and public disclosures. In addition, CEOs and CFOs must verify in every annual report that they have reviewed the report and that it does not include fallacious statements or omissions of material facts. In the case of a material noncompliance causing the company to amend its finances, the CEO and CFO will be deprived of any bonuses and other incentives received during the 12-month period following the initial filing of the flawed financial. After SOX, CEOs and CFOs are also accountable for establishing and maintaining in-house controls to guarantee that they are notified about bits and pieces of information. SOX includes rigid penalties for corporate and criminal fraud by company insiders. The penalties for those found guilty include fines, up to 20 years in prison, or both. Several papers have provided evidence regarding the effect of SOX on managerial and board decision making and their outcomes. For example, Link, Netter, and Yang (2008) find that SOX demanded more work from directors and increased directors' risk level. As a result, there was a significant increase in director compensation after SOX.

It is well established in the economics, psychology, and sociology literature that older employees find it difficult to compete with younger ones in the labor market. However, several studies have indicated that older employees possess the wisdom, reliability, experience, and knowledge necessary for a successful business (Kogan & Shelton, 1960; Taylor & Walker, 1998). Thus, existing literature regarding the labor market for older employees seems to be divided. These disparities apply to higher level executives as well. Several studies suggest that the age of the CEO plays an important role in corporate decision making. In this study, we focus on CEOs as they are the primary decision makers and it is their policies and preferences that set the precedence for the rest of the firm. Especially, we examine the implication of a regulatory intervention, like SOX, on the desirability and compensation of older CEOs as compared to younger ones.

Through multiple and robust analytical techniques including multivariate regressions (OLS, median regression, pooled regression, and fixed effects regression), regressions with interaction terms, regressions on split samples (based on CEO age), regressions using a propensity score matched sample and using additional ownership (governance) controls, we establish that total CEO compensation significantly increased in the post-SOX era as their exposure to risk and responsibilities increased due to SOX.

Further, we also provide evidence that compensation was greater for older CEOs after the implementation of SOX. One of the explanations for this higher pay for older CEOs could be that they are perceived as more ethical, credible, and responsible than young CEOs.

Our paper makes significant contributions to the literature. We add to the growing literature concerning the effects of manager-specific personal traits, like age, on corporate compensation. Our paper is among a small nascent stream of work that examines the impact of regulatory intervention on the demand for CEOs (perceived as favorable in the post-regulation period). We affirm the important influence of CEO age on CEO compensation. In fact, our evidence suggests that older CEOs have an "age advantage" in the post-SOX era as they are perceived as ethical, reliable, and responsible.

2. Literature review

The psychology and business literature provides two opposing views regarding the employment of older people. One line of thinking is that the older employees are difficult to train, find it harder to adapt, and are stereotyped. As a result, firms do not want to hire them. Zwick (2011) finds that the training (training effectiveness measured as career development, earning, adoption of new skills, flexibility, or job security) of older employees is less effective. Similarly, Henkens (2005) provides evidence that psychological mechanisms explain people's view about older employees as stereotypes. Using incentive theories, De Hek and Van Vuuren (2011) find that toward the end of an employee's career, wages exceed productivity. The model of Garen, Berger, and Scott (1997) predicts that benefit pension plans discourage the hiring of older workers. In contrast, Craft, Doctors, Shkop, and Benecki (1979) establish that older people are more ambitious and opinionated. Kogan and Shelton (1960) find that older individuals are wiser, while Finkelstein, Higgins, and Clancy (2000) provide evidence that older people are more experienced. Taylor and Walker (1998) establish that they are more productive. Thus, the existing literature concerning the labor market for older employees seems to be divided. As outlined above, one strand of literature suggests that older individuals have lower employability and are viewed as less valuable to the firm. However, the other strand of the literature implies that firms desire older employees because they are wiser, ambitious, experienced, and knowledgeable. This makes older employees indispensable and valuable to the firms. These opinions suggest that the evidence regarding the demand for older people in the labor market is divided.

However, the demand for older employees would be significantly impacted by the Key Result Areas (KRAs) or primary job responsibilities of a particular position. Specifically, due to the nature of the job and the huge difference in skills and expertise required, the labor market of chief executives (CEOs) of U.S. public companies will be very different from the general labor market of junior or mid-level employees. In this paper, we focus on the labor market for CEOs; particularly, we examine the differences in compensation between young and old CEOs. We discuss the previous

[3] See "Older workers Wanted for Experience, Credibility, Dedication" by Matt Sedensky, *The Associated Press*, September 13, 2013.

[4] See "Is 90 the New 80?" by Beth Kowitt, *Fortune*, August 16, 2013.