Incentive Pay Prior to CEO Turnover When Effort Choices Have Lasting Effects

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INTRODUCTION

- Incentive pay is a common and significant component of CEO compensation.
- We present a principal-agent model in which CEO effort choices have lasting effects on firm performance and examine optimal incentive pay.
- Anticipated CEO turnover reduces the impact of future performance pay and induces higher optimal sensitivity of current CEO compensation to current performance.
- We test this prediction empirically using a sample of over 3,000 US firms over 1992-2019.

PRINCIPAL-AGENT MODEL

- Analysis follows linear exponential (LEN) model.
- Introduce a link between the agent's current effort and firm performance in both current and future periods.
- Optimal one-period contract has a larger change in current compensation for a given change in current performance with higher anticipated likelihood of turnover.

HYPOTHESES

1. Higher sensitivity of incentive pay to a change in firm performance for CEOs who reach retirement age.
2. Higher sensitivity of incentive pay to a change in firm performance for CEOs close to planned departure.
3. No change in sensitivity of incentive pay to a change in performance for CEOs close to an unplanned departure.

DATA AND METHODOLOGY

- Final sample of 3,180 firms and 37,641 observations over 1992-2019.
- Data from *ExecuComp* and *CompuStat* databases.
- News reports used to identify planned / unplanned turnover.
- Executive-level fixed-effects regression analysis.

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We predict and find higher sensitivity of current incentive pay to current firm performance only when there is greater anticipated likelihood of executive turnover

- **Incentive pay** makes **close to 30%** of average CEO pay between 1992-2020
- Incentive pay has **strong and significant positive link** to firm performance
- Incentive pay becomes **more sensitive** to concurrent firm performance before CEO departures in a **planned succession** or when the CEOs reach **retirement age**

SENSITIVITY OF COMPENSATION TO FIRM PERFORMANCE BY TURNOVER TYPE

	Dependent : Incentive Compensation	Dependent : Salary Compensation	Dependent : Equity Compensation
Return on assets (ROA)	**1.730**** **(30.13)**	0.0554** (2.59)	0.398** (3.23)
ROA interacted with no CEO departure, CEO retirement age	**1.281**** **(5.14)**	-0.0647 (-0.70)	-0.134 (-0.25)
ROA interacted with planned CEO departure, CEO not retirement age	**2.238**** **(4.95)**	0.0018 (0.01)	0.796 (0.83)
ROA interacted with planned CEO departure, CEO retirement age	**2.665**** **(6.01)**	-0.137 (-0.82)	1.617 (1.71)
ROA interacted with unplanned CEO departure, CEO not retirement age	0.285 (1.92)	0.0015 (0.03)	0.106 (0.34)
ROA interacted with unplanned CEO departure, CEO retirement age	-0.439 (-0.75)	0.142 (0.65)	-2.149 (-1.72)
Log of book value of total firm assets	0.430** (54.11)	0.145** (36.18)	0.597** (39.99)
CEO tenure at firm	0.00887** (4.68)	0.00986** (10.58)	-0.0171** (-4.70)
Five dummy variables indicating types of CEO departure	Included	Included	Included
Time period dummy variables	Included	Included	Included
CEO-level fixed effects	Included	Included	Included
Observations	37,641	37,641	37,641

RESULTS

- Incentive pay has strong and significant positive link to firm performance.
- CEOs of retirement age have significantly higher sensitivity of incentive pay to firm performance.
- Among retirement-age CEOs, sensitivity of incentive pay to firm performance is approximately four times higher when their departure is part of a planned versus an unplanned succession.
- Among non-retirement-age CEOs who leave, sensitivity of incentive pay to performance is more than twice as high when they leave in planned versus an unplanned departure.
- Among unplanned departures, whether CEO of retirement age or not, there is no statistically significant difference in the coefficient on the ROA variable interacted with these groups of CEOs.

CONCLUSIONS

- Empirical results demonstrate that incentive pay is strongly and positively related to firm performance in a fixed-effects model.
- Only when the CEO is of retirement age or there is a planned succession, and thus there exists an anticipated increase in turnover likelihood, there is increased sensitivity of current CEO incentive pay to current performance.
- These results highlight the role of incentive pay in the overall executive compensation package.

- Full paper on ASSA program web site.
- Comments are welcome.

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