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.
• Optimal one-period contract has a larger change in current CEO compensation to current performance.

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
• Data from ExecuComp and Compustat databases.
• News reports used to identify planned / unplanned turnover.
• Executive-level fixed-effects regression analysis.

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

<table>
<thead>
<tr>
<th>Dependent : Compensation</th>
<th>Dependent : Compensation</th>
<th>Dependent : Compensation</th>
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</thead>
<tbody>
<tr>
<td>ROA interacted with no CEO departure, CEO retirement age</td>
<td>ROA interacted with planned CEO departure, CEO not retirement age</td>
<td>ROA interacted with planned CEO departure, CEO retirement age</td>
</tr>
<tr>
<td>1.730**</td>
<td>2.238**</td>
<td>1.015**</td>
</tr>
<tr>
<td>(13.03)</td>
<td>(5.14)</td>
<td>(3.60)</td>
</tr>
<tr>
<td>ROA interacted with no CEO departure, CEO not retirement age</td>
<td>ROA interacted with planned CEO departure, CEO retirement age</td>
<td>ROA interacted with no CEO departure, CEO retirement age</td>
</tr>
<tr>
<td>0.0554**</td>
<td>0.0105**</td>
<td>0.0171**</td>
</tr>
<tr>
<td>(25.59)</td>
<td>(4.95)</td>
<td>(1.72)</td>
</tr>
<tr>
<td>Return on assets (ROA)</td>
<td>Log of book value of total firm assets</td>
<td>CEO tenure at firm</td>
</tr>
<tr>
<td>0.398**</td>
<td>0.506**</td>
<td>0.0018</td>
</tr>
<tr>
<td>(57.23)</td>
<td>(36.18)</td>
<td>(0.00)</td>
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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.

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.