Assignment 6. Solution

Executive compensation problem

a. If shareholders have information about executive compensation, such as amounts and types of compensation, they can relate this pay package to share price performance and can thus make informed decisions on whether the executives are overpaid in relation to their performance. If they feel these are out of line, they can bring pressure on the firm to change the compensation contract. This is particularly so if shareholders have a say on pay. Alternatively, or in addition, they can bid down the firm's share price.

With respect to risk, if the manager earns high compensation because the firm has adopted very risky strategies which have paid off, investors should be aware of this, since future risky strategies may not be so fortunate. This supports the disclosure of the relationship between compensation and risk management.

b. Awarding incentive compensation in the form of ESOs and/or restricted stock is intended to give senior executives a longer-term decision horizon. A longer-term horizon discourages short-term, opportunistic actions that are dysfunctional towards the firm's longer-term interests, such as cutting maintenance, cutting R&D, or manufacturing for stock so as to bury overhead costs in inventory. Managers who hold company options and/or shares will realize that the market will punish the firm's share price upon becoming aware of such actions, thereby lowering the value of their holdings.

c. If executive pay is too dependent on longer-term incentives, the executive will bear considerable non-diversifiable compensation risk, particularly if the performance measure is low in precision (that is, highly affected by factors that the manager feels are not informative about his/her effort in generating future payoffs). Then, to maintain reservation utility, the manager may demand higher expected pay to compensate for the greater risk, or change operating policies. Operating policy reactions to excessive compensation risk include adoption of strategies that involve relatively safe returns, and/or excessive hedging. Such actions are not necessarily in the best interests of the firm and its (diversified) shareholders. However, if share-based compensation is in the form of ESOs, which have limited downside risk, the manager may adopt very risky operating policies, since he/she has everything to gain and little to lose. Some balance between these two types of longer-term incentives seems desirable. Also, there are times when a short run decision horizon is in the firm's best interests, such as a need to cut costs or conserve cash. Longer-term decision horizons may work against these policies. Some balance between ESOs and short-term incentive awards is desirable.

Finally, if vesting periods are short and the manager is free to dispose of shares acquired, ESOs can generate incentives to opportunistically increase share price in the short run, the opposite of the longer-run decision horizon they are intended to create.

d. A well- working managerial labour market is one in which the manager's market value (equivalently, the reservation utility he/she can command), reasonably reflects the manager's ability. The compensation disclosure requirements add to the stock of publicly available information about managers. This information includes the types and amounts of compensation, the compensation committee's evaluation of the manager's ability and performance, and additional information about risk management so that investors can evaluate the manager's compensation relative to the riskiness of his/her operating policies. Then, the ability of the market to evaluate manager ability, compare compensation cost to the value of the manager's services, and the extent to which the manager may engage in opportunistic behaviour is improved. That is, the market works better. However, to the extent the power theory of executive compensation holds, the effectiveness of these disclosure requirements will be reduced, since the manager may have enough power in the organization to attain excessive compensation anyway. Note that the power theory includes tactics whereby the CEO may do this, namely disguise excessive compensation and reduce public outrage.

A reasonable conclusion is that the disclosure requirements will improve the working of the managerial labor market, since they increase publicly available information about manager ability, performance, and risk, and make it more difficult for the manager to attain excessive compensation.

e. Under labor market efficiency, the manager's market value reflects only publicly available information. To the extent this information is incomplete or biased, we cannot completely rely on managerial labor market forces to provide incentives for managers to work hard. One reason is moral hazard, leading to earnings management to cover up shirking. While the disclosure requirements may assist the managerial labor market to work well, it is unlikely that they will enable full public knowledge of the manager's fundamental value. One reason is that the requirements say nothing about earnings management—controlling this is the responsibility of the accountant/auditor and GAAP. The disclosure requirements do include a "detailed explanation" of the compensation of the five highest-paid firm executives and a report from the compensation committee justifying the pay levels. Also, disclosures of the relationship between compensation and risk are required. However, these requirements are quite general and subjective and do not guarantee that every relevant aspect of manager performance will be taken into account or disclosed (consider, for example, evidence that compensation committees are less likely to penalize the manager for non-recurring losses than to reward them for non-recurring gains). Then, market forces of competition are hampered in their ability to drive compensation to a level that reflects the manager's fundamental value. Consequently, incentive plans are still needed. (Cf. Wolfson, 1985 & Bushman, Engel, and Smith, 2006).