The dark side of CEO incentive-based pay

March 24 2016, by Melody Walker

New research from Washington University in St. Louis reveals the consequences of executive pay-for-performance packages.

When a publicly traded company meets a pay-for-performance target, it may be lauded by Wall Street investors. New research from Washington University in St. Louis shows it can also be cause for concern.

A new study based on data culled from the filings of more than 700 of the largest publicly traded firms in the U.S., finds that, on average, firms with executive pay-for-performance packages based on specific earnings-per-share (EPS) targets are probably manipulating their revenue numbers in order to hit the target.

Managing or manipulating reported performance is what the Olin Business School co-authors call the "dark side" of executive incentive contracts.

"There's no evidence of fraud in our findings," said Todd Milbourn, the Hubert C. and Dorothy R. Moog Professor of Finance. "What we refer to as the 'dark side' of performance-driven compensation is really a focus on the unintended consequences that happen when you're trying to meet a particular goal."

Milbourn said those consequences typically involve cutting spending on research and development, or advertising, to boost short-term profits to meet the performance goals tied to pay. Over the long term, these kinds of repeated trade-offs will negatively affect broader firm goals and shareholder value, according to the researchers.

Milbourn co-authored the new study, "Compensation Goals and Firm Performance" with Olin colleague Radhakrishnan Gopalan, associate professor of finance; Benjamin Bennett, assistant professor, Air Force Institute of Technology; and Carr Bettis, research professor of finance, W.P. Carey School of Business, Arizona State University. The paper is the 2016 recipient of the Olin Award for Research that Impacts Business and is under review at the *Journal of Financial Economics*.

Until this study, obtaining reliable data on compensation packages linked to specific performance targets has been difficult. The SEC does not require firms to report this information separately from company proxy statements. Using the latest intelligent software technology to sift through all the fine print and footnotes in company filings, the researchers identified specific performance targets to compare with actual performance as reported by Compustat.

Information on all the cash, stock and option grants awarded to the top five highest-paid executives for the 750 largest firms by market capitalization over the time period 1998-2012 also was part of the massive data base compiled by the professors for their research.

Innovative data collection is just one of the unique aspects of this research: the researchers also applied advanced statistical techniques for the first time to the existing literature in this field of financial research. This allowed them to compare the number of firms that just failed to meet their targets to the number of firms that meet their targets by a very small number—often by a penny above the EPS goal.

Gopalan said in such a large sample, the results should be randomly distributed on either side of the target, but what they found was the group of firms that just beat the target is disproportionately large compared to the group that just failed to meet the target.

The results raised a red flag and after more analysis, Gopalan said the evidence was clear. "The reason why a large number of firms beat the target by as little as a penny is that they are actively managing their reported performance," he said.

Gopalan and his co-researchers concede this manipulation is not illegal, but they are concerned about the consequences it sets in motion. "From our perspective, to what extent does this pay feature result in management doing actions that may not be in the best interest of long term shareholder value?" he asked.

The finance researchers offer a fix to what they see as a flaw in compensation packages tied to specific performance targets.

"Our paper offers a prescription as to what not to do and hence what to do when designing CEO compensation plans," Gopalan said. "Focusing on specific performance metrics alone is not a bad thing, but when you link pay to those performance metrics, use a more continuous, linear relationship that does not focus on specific, short term targets that you want the CEO to achieve.

"Linking pay to those targets has a lot of negative dark sides to it which you can avoid. Incentivize the CEO to focus on the metrics that the Board of Directors and shareholders care about with bonuses tied to multiple performance measures," Gopalan said.

More information: "Compensation Goals and Firm Performance," apps.olin.wustl.edu/faculty/milbourn/Performance%20Metrics.pdf

Provided by Washington University in St. Louis