Compensation Disclosure and Pay-for-Performance in Top Management

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Bachelor of Science

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Purpose/Motivation: Expanding regulation on compensation disclosures for top management continues to be introduced around the world. A primary concern of such legislation and shareholders is to align the pay of executives with firm performance. Nevertheless, prior research examining the effects of mandated compensation disclosures on the strength of the link between top management pay and firm performance has mixed findings ranging from positive to negative effects. Unlike these studies, this paper focuses on multiple regulations and categorizes disclosures into two different types, pay process and pay outcome disclosures, allowing me to assess how different aspects of mandated disclosures affect the link between top management team (TMT) pay and firm performance.

Theories/Hypotheses: A central theory of this paper is the principal agent theory by Jensen and Meckling (1976). When ownership and management are separated, managers might behave in ways that are best for them, but not necessarily best for the firm (Jensen & Meckling, 1976). In contract settings, risk averse management will try to formulate less performance sensitive contracts and extract as much value as possible (Bebchuk, Fried & Walker, 2002). In case powerful managers are able to determine their own pay as the managerial power approach suggests (Bebchuk & Fried, 2003), then contracts would be highly inefficient with little to no pay for performance (PFP). When pay processes (e.g., compensation setting, pay components, performance compared to peer groups, benchmarks) are mandated to be disclosed, such inefficiencies and rent extraction would be obvious to shareholders. This would allow them to adjust compensation of the TMT and make contracts more efficient, with pay closely linked to firm performance. This leads to **Proposition 1**:

Mandated TMT compensation disclosures focusing on pay processes, increase the strength of the link between TMT compensation and firm performance.

Other than the managerial power approach, the efficient contracting approach argues that executive pay is set through supply and demand for managerial talent with efficient contracts that align the interests of shareholders and managers through incentives (Murphy, 2013). In this case contracts already are highly performance contingent and disclosing pay processes would not improve them.

Proposition 2 is therefore:

Mandated TMT compensation disclosures focusing on pay processes have no effect on the strength of the link between TMT compensation and firm performance.

Disclosures on pay outcomes (absolute levels of pay, pay ratios) likely have a very different effect on the PFP sensitivity. The absolute compensation of the TMT is irrelevant for shareholders as long as firm value is maximised (Edmans, Gabaix & Jenter, 2017). But such disclosures are very relevant for the TMT and third parties. Social comparison theory states that people will compare their abilities with those of others to evaluate their performance, with a focus on others who are similar to themselves (Festinger, 1954). When pay outcomes are disclosed, the TMT knows how much comparable others earn. Executives finding themselves on the lower end of disclosed pay levels will likely find themselves unjustly underpaid. Firms then have to increase pay to avoid losing their executives (Ezzamel & Watson, 1998), independent of actual performance, reducing the strength of the link between pay and performance. Third parties will further reduce PFP sensitivities when pay outcomes are disclosed, because public outrage over very high compensation levels of the TMT limit the upper range of pay levels (Jensen & Murphy, 1990), meaning high pay-outs for stellar performance in efficient contracts are no longer viable. Both effects lead me to **Proposition 3**:

Mandated TMT compensation disclosures focusing on pay outcomes decrease the strength of the link between TMT compensation and firm performance.

Approach/Methodology: I conducted a literature review to identify relevant papers, that examined how mandated compensation disclosures affect the link between pay and performance for the TMT. I then analyzed them and categorized the respective laws and regulations into pay process and pay outcome disclosures to assess how the findings translate to my propositions. The final sample consisted of 13 papers, with nine of them focusing on pay process disclosures and four on pay outcome disclosures.

Findings: Mandatory disclosures focusing on pay processes strengthen the link between TMT pay and firm performance. The mandated disclosure of pay outcomes, however, seems to weaken the PFP link.

Research Limitations: The evidence on pay outcome disclosures was rather limited, with only four studies available of which three did not include time periods with multiple years post disclosure. Also measures of pay and firm performance varied widely between the different studies, making some findings difficult to compare and limiting generalizability. Another issue is that some regulations focus on both, pay outcomes and pay processes and can

therefore not be clearly categorized. In these instances, only a combined effect could be found which might be different than the effect of separate disclosures would have been.

Research Implications: The review showed a need for more evidence, including multiple years after new disclosures are introduced, to solidify findings on pay outcome disclosures. Also, a more uniform approach regarding measures of pay and performance in the field could help make findings comparable and lead to less variation in the results.

Practical Implications: Policymakers have to consider what aspects are disclosed when designing new disclosure laws. In case aligning pay and performance is a primary goal of such legislation, this paper suggests using disclosures on pay processes while restraining from disclosing pay outcomes.

Contribution: This paper contributes to the executive compensation literature in general and emphasizes a need for distinguishing between different aspects of disclosure when examining effects of mandated disclosure regulation.

Paper type: conceptual

Further readings:

Arnold, A., & Fulmer, I. S. (2018). Pay Transparency. In S. J. Perkins (Ed.), *The Routledge Companion to Reward Management* (1st ed., pp. 87–96). Routledge. https://doi.org/10.4324/9781315231709-11

Chang, W., Dambra, M., Schonberger, B., & Suk, I. (2023). Does Sensationalism Affect Executive Compensation? Evidence From Pay Ratio Disclosure Reform. *Journal of Accounting Research*, *61*(1), 187–242. https://doi.org/10.1111/1475-679X.12458

Jensen, M. C. & Murphy, K. J. (1990b). CEO Incentives: It's Not How Much You Pay, But How. *Harvard Business Review*, No. 3, 138-153. http://dx.doi.org/10.2139/ssrn.146148

Murphy, K. J. (2013). Executive Compensation: Where We Are, and How We Got There. In *Handbook of the Economics of Finance* (Vol. 2, pp. 211–356). Elsevier. https://doi.org/10.1016/B978-0-44-453594-8.00004-5