

Cost Shielding in Executive Bonus Plans

(Bloomfield et al. 2019)

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My Impression

- Important paper with useful stylized facts
 - I learned something!
- What would I do next?
 - Explore additional test using FAS 123-R
 - Address some alternative hypotheses
 - Try to tackle the “so what? question”

1. Additional test

- Ideal experiment
 - Change a cost item without changing firm fundamentals
 - See how board responded to change in cost item in terms of cost shielding
- FAS 123-R in 2005
 - Option compensation costs moved from footnotes to income statement
 - No change in fundamentals; staggered compliance (Ladika/Sautner 2019)
 - Board should adjust bonus pay to shield against it
- Do we see a response?
 - If board shield CEOs from costs, we should see a change in bonus contracts from before to after

2. Alternative explanations

- Industry factors?
 - Cost shielding may be driven by characteristics of a firm's industry
 - Explore explanatory power of industry fixed effects?
 - Analysis currently only uses year fixed effects
- Managerial opportunism?
 - Substantial year on year variation in cost shielding
 - CEOs may exercise power to remove less beneficial cost items
 - Estimate Removal = $f(\text{Change in Cost Items; ...})$
 - Explore how sensitivity of cost shielding varies with managerial power
 - CEO Pay slice; E index; etc.

3. So what?

- “Bonus plans mitigate agency conflicts”
 - What agency problems do you have in mind and how do your hypotheses relate to them / how does cost shielding reduce them?
- Taking results at face value, want to see that shareholder value is affected if cost shielding creates value
- Currently no links to performance or returns
- Can you see any financial disadvantages from suboptimal cost shielding?
 - Create measure of deviation from optimum (industry average) and relate to performance or valuation measure

4. Smaller Questions

- What is the role of compensation consultants?
 - Do board really design structure of bonus pay?
 - Evidence that pay consultants play an important role
 - Murphy and Sandino (2010)
- How important is bonus pay overall?
 - Is it a first order component of total pay? Should be care?
 - Add summary stats relative to equity pay

4. Smaller Questions (continued)

- How do you account for other performance criteria in bonus plans
 - About 40% of performance measures are not IS measures
 - Measures are likely interrelated, affect incentives
 - For example, relative performance also allows for cost shielding if systematic across industry
- Key result: “More cost shielding when costs are noisier”
 - Makes sense from contract theory perspective (risk averse CEOs)
 - Empirical measure is volatility in cost items over past ten years
 - Wouldn't informativeness principle (Holmström) suggest use of an idiosyncratic measure? Firm-specific volatility?

Thank you and good luck with the paper!