Management Compensation And
The Managerial Labor Market

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Abstract

The papers in this volume and briefly summarized in this introduction document that: (1) executive compensation is positively related to share price performance; (2) poor firm performance is associated with increased executive turnover; (3) managers choose accounting accruals in ways, that increase the value of their bonus awards; (4) the adoption of new short- and long-term executive compensation plans and golden parachutes are associated with positive share price reactions; (5) the death of a firm’s founder is associated with positive share price reactions; and (6) managers are less likely to make merger bids that lower their stock prices when they hold more stock in their firm. These findings are interpreted as generally supporting the view that executive compensation packages help align managers’ and shareholders’ interests.

Keywords: executive compensation, share price performance, golden parachutes, share price reaction, manager and shareholder interest

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This volume contains the papers and discussants’ comments presented at a conference in honor of William H. Meckling titled “Management Compensation and the
Managerial Labor Market”. The conference, jointly sponsored by the Managerial Economics Research Center and the Journal of Accounting and Economics, was held at the University of Rochester on April 26-28, 1984. It was designed to promote interaction among scholars in accounting, finance and economics who are studying the market for managers and the economics of managerial compensation, including the implications of alternative compensation plans for the behavior of corporate managers. We hope the conference discussions and publication of the papers encourages further work in these important areas.

Management compensation and related issues of corporate governance have become major topics of discussion in the media and in the political and regulatory sectors. Unfortunately, there is much confusion and misinformation about these topics. For example, an extreme view that has received considerable attention holds that executives do not act in their shareholders’ interests and that they control their boards of directors. It is asserted that executives are paid too much, that executives’ pay is independent of the performance of their firms, and that executives do not lose their jobs for poor performance. The conference papers and discussion did not address the level of executive pay. With this exception, the conference papers provide evidence these beliefs are incorrect.

The general conclusion that emerges from the studies published in this volume is that compensation packages of top level executives help align managers’ and shareholders’ interests.

Executive compensation: Aligning shareholders’ and managers’ interests

The nine papers in this volume provide direct and indirect evidence on the incentive effects of executive compensation packages. The papers are grouped into the following five subject areas: (1) relation between compensation and firm performance, (2) effects of bonus plans on accounting choices, (3) stock price
reaction to executive contract changes, (4) stock price reaction to executive deaths, and (5) compensation incentives and mergers and acquisitions. For expanded summaries of most of the papers, the reader is referred to the discussants’ comments and to the concluding overview by Artur Raviv (1985).

(1) Relation between compensation and firm performance [Murphy (1985), Coughlan-Schmidt (1985), and Benston (1985)]

Murphy, in a study of 461 executives in 72 companies over 18 years, and Coughlan-Schmidt, in a study of 249 executives from 249 companies over 4 years, document that changes in executive compensation are positively related to current year stock price changes. While the relation between changes in executive pay and changes in shareholder wealth is statistically significant, much of the variance in executive compensation remains unexplained. This low correlation is not surprising since the forces determining optimal changes in executive compensation are many and complex. Thus it would be surprising if stock price changes explained a high percentage of the variance in executive pay. This makes even more sense in light of the evidence presented by Benston and Murphy that executives hold relatively large amounts of their firms’ common stock. They show that annual changes in the value of these shareholdings (both positive and negative) are often 3 to 5 times greater than the executive’s total annual cash compensation. Thus, independent of the relation between annual compensation and firm performance, executives experience large wealth changes as a direct result of firm performance as reflected in stock prices.

Coughlan-Schmidt and Benston also document that stock price performance and subsequent executive turnover are negatively correlated. The evidence is consistent with the hypothesis that poor performance increases the probability that top-level managers lose their jobs.
These three papers, taken collectively, suggest that executive compensation plans, board level discipline of poorly performing managers, and managers’ shareholdings in their firms help align the interest of managers and shareholders.

These papers also provide important methodological insights regarding the use of executive compensation and turnover data in proxy statements and other published sources. For example, by comparing cross-sectional and time series analyses of the pay-performance relation. Murphy explains why earlier cross-sectional studies failed to find a relation between pay and firm performance. He argues that omitted variables such as firm size that are correlated with the performance measure will bias the estimated pay-performance relation in cross-sectional regressions. Coughlan-Schmidt discuss the problems involved with using the compensation data reported in published sources such as *Forbes*.

(2) *Effects of bonus plans on accounting choices* [Healy (1985)]

Healy provides evidence that managers of firms with bonus plans choose accounting accruals to increase the value of their bonus awards. Bonus plans commonly contain accounting-based upper and lower bounds that constrain the bonus payout. Healy concludes that managers seeking to increase their bonuses are more likely to choose accruals that decrease accounting income when the upper or lower bounds on their bonus plan are binding. In addition, when these bounds are not binding, he concludes that managers choose accruals that increase accounting income.

(3) *Stock price reaction to executive contract changes* [Brickley-Bhagat-Lease (1985), and Tehranian-Waegelein (1985)]

These two studies find that on average stock prices rise by about 11% at the time of the first public announcement of adoptions of short-term executive compensation plans or changes in such plans and by about 2% at the time of adoption of long-term compensation plans. These plans typically reward managers for
performance based on the current year (short-term plans) or several years (long-term plans). Tehranian-Waegelein also find that firms which adopt short-term compensation plans experience positive abnormal stock returns prior to the announcement of the plans. Favorable shareholder reaction to establishment of these plans results from any or all of the following reasons: (i) compensation plans help align managers’ and shareholders’ interests (incentive hypothesis), (ii) compensation plans are adopted when managers expect favorable future operating results (information hypothesis), or (iii) compensation plans are adopted to minimize the joint tax liability of the firm and its managers (tax hypothesis). The evidence does not discriminate among these alternative hypotheses but the authors suggest future work in this direction.

Tehranian and Waegelein also document that firms which adopt short-term plans experience strong positive performance in the year after adoption. Ninety percent of the firms in the sample announced annual earnings that were unexpectedly high in the 11 months after adoption of the plan. Moreover, the firms which adopted short-term plans experienced average abnormal stock price increases of about 8% over this 11-month period. This evidence is consistent with the hypothesis that managers respond to the incentives of new compensation plans in ways that increase shareholder wealth. The puzzling aspect of these results is their inconsistency with the efficient markets hypothesis. They indicate one can make above normal profits by purchasing shares of firms that adopt new short-run compensation plans. Further work to document and understand this apparent market inefficiency is warranted.

Finally the positive stock price effects associated with the adoption of executive bonus plans suggest that the costs from the effects on managerial choice of accounting accruals documented in Healy’s study are smaller than the anticipated benefits from the plan. One explanation for these results is that subsequent
managerial opportunistic behavior is taken into account in the establishment and administration of the overall provisions of the bonus plans so that managers do not earn above-normal compensation.

(4) Stock price reaction to executive deaths [Johnson-Magee-Nagarajan-Newman (1985)]

This paper finds that stock prices experience a statistically significant 3.5% increase when a firm’s founder dies unexpectedly while holding a top-level executive position. In contrast, when non-founder senior executive deaths occur, stock prices fall a statistically insignificant 1%. The authors discuss various reasons for these findings. One possible interpretation is that the founders were not operating the firm in the shareholders’ interests. Another hypothesis is that the founder’s death reveals an increased probability of takeover (that might occur when the usually large stockholdings of the founder’s estate are settled). However, the evidence suggests that takeover expectations are not responsible for the positive abnormal returns at the time of the founder’s death.

(5) Compensation incentives and mergers and acquisitions [Lambert-Larcker (1985), and Lewellen-Loderer-Rosenfeld (1985)]

The Lambert-Larcker paper documents a statistically significant 3% average abnormal stock price increase associated with the announcement of ‘golden parachute’ contracts that compensate managers if they leave their firm subsequent to a change in control. These contracts help align managers’ and shareholders’ interests regarding outside takeovers by eliminating managers’ incentives to block takeovers that benefit shareholders at the expense of managers’ jobs. The observed positive abnormal returns at announcement of the golden parachute is consistent with the hypothesis that the contracts resolve a serious potential conflict of interest between shareholders and managers. The results are also consistent with the hypothesis that
the adoption of a golden parachute reveals a future takeover is more likely and that
stock prices are responding to the anticipation of a takeover premium. While the
Lambert-Larcker tests are unable to differentiate between these two hypotheses, they
are able to reject the hypothesis that golden parachutes benefit managers at the
expense of shareholders.

Lewellen-Loderer-Rosenfeld find weak evidence that managers making
merger bids are less likely to undertake unprofitable acquisitions (i.e., those that
reduce the bidders’ stock price) when the managers hold large fractions of their
companies’ stock. They reason that such large inside shareholdings impose more of
the wealth consequences of such acquisitions on senior managers and thus more
closely align managers’ and shareholders’ interests.

The evidence in the Walkling-Long (1984) paper (also presented at the
conference but previously committed for publication elsewhere) reinforces the
findings of the Lewellen-Loderer-Rosenfeld paper. Walkling-Long find that managers
of firms facing takeover bids are less likely to oppose the bids when the benefits to
target managers from the tender offer are larger. The benefits to managers are
estimated by changes in the value of managerial stock holdings that would occur if
the offer were successful. These findings also suggest that large managerial
shareholdings reduce manager-shareholder conflicts of interest at times of takeovers.

The findings of Lewellen-Loderer-Rosenfeld and Walkling-Long appear to be
inconsistent with those of the Johnson-Magee-Nagarajan-Newman paper on executive
deaths. Large managerial shareholdings appear to benefit shareholders of firms
involved in acquisitions but share prices of firms rise when founders (who generally
have very large shareholdings) die. The reason for the apparent discount in share
prices for founder-run firms in the period prior to founders’ deaths may lie in the
special relation between founders and their firms. Future work is necessary to clarify this issue.

Conclusions

In summary, the papers in this volume are consistent with the conclusion that executive compensation plans help align managers’ and shareholders’ interests. Executive compensation and executive turnover are positively related to stock price performance; and the adoption of short- and long-run compensation plans and golden parachutes are associated with increases in shareholder wealth. While these findings suggest that the incentive effects of compensation plans are important, the relative importance of incentive, tax, information, and signaling effects on the determination of executive compensation plans is yet to be sorted out [see Raviv (1985)]. Finally, the evidence is inconsistent with the view that executive compensation is unrelated to firm performance and that executive compensation plans enrich managers at the expense of shareholders.

These papers do not provide the last word on executive compensation. For the most part, however, these papers set the standards for subsequent work in the area. They also indicate that management compensation and share ownership data disclosed in proxy statements provide productive sources of information for further research into the economics of organizations.

Unfortunately, the studies in this volume do not address the complex issues associated with the frequently made, but unsupported, assertion that executive compensation is ‘too high’. Although it is possible to make equally plausible, but also unsupported, assertions that executive compensation is ‘too low’, such arguments have received no attention in the media. More work is required, to address the difficult and important economic issues associated with whether executive pay is ‘too low’ or ‘too high’.
The conference honored William H. Meckling, Dean of the Graduate School of Management at the University of Rochester from 1964 to 1983. During his 19-year tenure as Dean, Bill Meckling imparted the standards, character and flavor of Rochester’s business school. He created a unique institution in Rochester’s GSM—an institution devoted to solving managerial and organizational problems as well as important public policy issues, and an institution populated by scholars with a deep commitment to the application of science in the pursuit of these solutions. His impact on management education through both his administrative and leadership accomplishments evidenced in the creation of the Rochester Graduate School of Management and through his own scholarly endeavors has been substantial.

To Dean Meckling the GSM at the University of Rochester was both an organization to produce management research and an organizational laboratory that provided tests of his hypotheses. The school provided its intellectually curious Dean with numerous (but often exasperating) opportunities to learn how incentives affect performance and how one implements and manages incentive schemes that reduce the ‘agency costs’ arising in a ‘rational, evaluative, maximizing’ faculty.

William Meckling’s after-dinner remarks, ‘Three Reflections on Performance Rewards and Higher Education’, also appear in this volume. They illustrate his curiosity about the world around him, his talent at applying economic analysis to explain that world, and his ever present enthusiasm for organizational questions.

The dedication of this volume of the Journal of Accounting and Economics to William H. Meckling is a tribute to his scholarly contributions to the economics of organizations.
References


