Cost Shielding in Executive Bonus Plans

(Bloomfield et al. 2019)

Discussion by Zacharias Sautner

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(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!