Groen-Xu, Huang, Lu, 2017, “The Role of Boards in CEO Assessment: Evidence from Stock Returns after Subjective Performance Reviews”

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The Question

Do boards do their jobs?

The Idea

- Do real salary increases (without increases in equity pay) predict future performance?

- If so, then boards must be incorporating unobservable soft information into their assessments

The Data

- Firms part of S&P 500 firms in any year between 1994 and 2008
- Execucomp data
- 649 employment contracts
- Code review clauses in contracts and reasons for raises in proxy statements

Analysis and Results

- Do stand-alone salary raises seem to be associated with an explicit review process: *Yes*, *they are positively associated with review clauses*
- Is performance related to stand alone salary raises? *Yes*, *particularly when review clauses*
- Is this effect stronger when greater information asymmetry? *Yes*
- Is this effect stronger when boards better? *Yes*
- Does information asymmetry predict review clauses? *Yes*

What I like about the paper

- We know little about CEO contracts
- Novel data
- Interesting way of testing whether boards do their jobs

Some questions

- The data
- The story
- The role of the board

Basic question: who gets a raise?

Table 5: Stand-alone salary increases and reasons

Panel A: Compensation changes				
Dependent variable	Stand-alone salary increase		Overall compensation increase	
	(1)	(2)	(3)	(4)
Review requirement	0.075**	0.067*	0	0.011
	(0.038)	(0.039)	(0.022)	(0.020)
Review factor		0.021		0.042*
		(0.045)		(0.022)
Mills		0.062		-0.049**
		(0.057)		(0.020)
Year fixed effects	Yes	Yes	Yes	Yes
Tenure group	No	Yes	No	Yes
Age group	No	Yes	No	Yes
Industry fixed effects	No	Yes	No	Yes
N	954	954	862	862

Suggestion

- Would like to see firm and CEO characteristics included
- Would like to see distribution of salary increases
  - Ability to evaluate economic significance
  - Ensure no compensation outliers

Example From Guthrie, Sokolowsky and Wan (2012)

Table II
CEO Pay at Fossil and Apple, 2000 to 2005

Year	Salary	Bonus	Restricted Stocks	Options Grant (Black-Scholes value)	All Other Compensation	Total Pay
Panel A: Compensation for Kosta Kartsotis at Fossil[a]						
2000	$255,000	$0	$0	$0	$35	$255,035
2001	$255,000	$0	$0	$0	$21	$255,021
2002	$255,000	$0	$0	$0	$17	$255,017
2003	$255,000	$0	$0	$0	$324	$255,324
2004	$255,000	$0	$0	$0	$220	$255,220
2005	$0	$0	$0	$0	$180	$180
Panel B: Compensation for Steve Jobs at Apple[b]						
2000	$1	$0	$0	$600,347,400	$0	$600,347,351
2001	$1	$43,511,534	$0	$0	$40,484,594	$83,996,129
2002	$1	$2,268,698	$0	$89,444,690	$1,302,795	$93,016,179
2003	$1	$0	$74,750,000	$0	$0	$74,750,001
2004	$1	$0	$0	$0	$0	$1
2005	$1	$0	$0	$0	$0	$1

- They show that these 2 outliers drive all results in Grinstein and Chhaochharia (2009)

What are raises for?

- Reward for performance or incentive or retention?
- What is relation to bonus?
- The story matters for identification

Table 7: Stock return regressions

Dependent variable	Monthly stock return after 1 year			Monthly stock return after 2 years		
	(1)	(2)	(3)	(4)	(5)	(6)
Stand-alone salary increase	0.003***	0.003***	0.002**	0.002**	0.002**	0.000
	(0.001)	(0.001)	(0.010)	(0.001)	(0.001)	(0.010)
Other controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm cluster	Yes	No	No	Yes	No	No
Two way cluster	No	Yes	No	No	Yes	No
Fama-Macbeth	No	No	Yes	No	No	Yes
N	96,695	96,695	96,695	96,683	96,683	96,695

return 2 years after compensation changes. The independent variable is the dummy variable indicating stand-alone salary increases. Control variables include one-, two-, and three-month lagged returns, firm size and market-to-book ratio. We estimate pooled regression in columns 1, 2, 4, and 5. Standard errors are clustered by firm in columns 1 and 4 and by firm and year-month in columns 2 and 5. Fama and Macbeth (1973) regressions are estimated in columns 3 and 6.

- Not clear that sufficient observable measures included here and elsewhere

Suggestions

- Would like to see a bit more discussion of theory behind subjective reviews

- More upfront discussion of what trying to identify (Correlation? Predictive power? Causal effect?) would be useful

Why commit to review clauses?

CEOs without disclosed contracts

CEOs with contractual review clauses

CEOs with contracts but without review clauses

CEO contracts: some context
(Schwab and Thomas, 2006)

Once the search committee decides on its first choice, it will in most cases offer that candidate the position. The principal economic terms of its offer will be set forth in a term sheet.[7] The term sheet, or its oral equivalent, will set forth the proposed salary, target bonus, equity participation in the company (stock options, restricted stock, and any long-term incentive plans), severance package, change-in-control protections, benefits (health plans, supplemental executive retirement plan, deferred compensation, etc.), and standard perquisites. It would also cover such items as relocation expense payments, the term of years for the contract, the renewal provisions for the contract, the duties associated with the position, and the physical location for the executive. The executive and the company's representatives then negotiate any changes to these items with the ESF sometimes asked to act as an intermediary, subject to

CEO contracts: some context
(Schwab and Thomas, 2006)

After the final term sheet is completed, both parties to the agreement will generally have their counsel negotiate the language and legal terms of the employment contract.[8] The company may choose to use inside counsel, or, in some cases, the company's outside lawyers, to handle the legal part of the negotiations. The executive will always retain an independent lawyer to handle the drafting or revising of any agreement. The language of the contract that ultimately comes out of this process, as in any negotiation, will reflect the relative bargaining strength of the parties, although some parts of the contract will be more heavily negotiated than others.

Questions

- Is a review clause a firm-specific or a CEO-specific characteristic? Or both?

- If firm-specific: Are the boards different?

- Some types of boards are good at using soft-information, others are not?

Suggestions

- More firm characteristics?

- Board characteristics?

Are independent boards that are not busy more effective?

- Standard arguments about board "effectiveness" may not be the ones that are relevant here

- Question is what type of board is better able to assess the CEO

Are independent boards that are not busy more effective?

- Independence:
  - More than 70% of firms nowadays have only one insider on the board—the CEO
  - Post-2002 reforms, all compensation committees are fully independent, many were independent before

→ Not clear that looking at *board* independence matters

Busy boards?

```
. reg comp_mem bus age female lnat bsize i.year i.twodigitsic if classifi~="E",cluster(newgvkey)

Linear regression                               Number of obs     =    108,607
                                                F(77, 2752)       =          .
                                                Prob > F          =          .
                                                R-squared         =     0.0787
                                                Root MSE          =     .47896

                          (Std. Err. adjusted for 2,753 clusters in newgvkey)
```

comp_mem	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
bus	.0598982	.0055483	10.80	0.000	.049019	.0707774
age	.0038126	.0003333	11.44	0.000	.003159	.0044663
female	-.0141531	.0090044	-1.57	0.116	-.0318091	.0035029
lnat	-.0061125	.0020468	-2.99	0.003	-.010126	-.0020991
bsize	-.0232202	.001051	-22.09	0.000	-.025281	-.0211594

- Riskmetrics (now ISS) until 2009, bus =1 if 2 or more outside directorships

Compensation specialists?

```
. reg numcomp bus age female lnat bsize i.year i.twodigitsic if classifi~="E",cluster(newgvkey)

Linear regression                               Number of obs     =    136,959
                                                F(79, 2982)       =          .
                                                Prob > F          =          .
                                                R-squared         =     0.2502
                                                Root MSE          =     5.0599

                           (Std. Err. adjusted for 2,983 clusters in newgvkey)
```

numcomp	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
bus	5.365296	.0846741	63.36	0.000	5.19927	5.531321
age	.049177	.0037614	13.07	0.000	.0418019	.0565521
female	.1791299	.1232033	1.45	0.146	-.0624422	.4207019
lnat	.3797893	.0310552	12.23	0.000	.3188975	.4406811
bsize	-.1105047	.0129774	-8.52	0.000	-.1359503	-.0850591

Suggestions

- Relate board characteristics to assessment
  - Other CEOs on board?
  - Directors with industry expertise on board?

- Focus on compensation committee

What about the banks?

- Contract example in paper is for Morgan Stanley
- Banks don’t have much R&D
- Banks presumably do not have many new product announcements
- But many argue they are opaque

→ Interesting to look at separately

Conclusion

- Interesting paper about an understudied phenomenon
- More papers can be written!
- Clever strategy to look at the role of boards

- I hope it does well!