

# [Improving pay for performance with sop](https://assignbuster.com/improving-pay-for-performance-with-sop/)

INTRODUCTION:

Executive pay has been a big controversial issue over the past twenty years due to various governance failures which have generated a forceful policy debate on the appropriate role of shareholder “ voice” in corporate governance (e. g., Bebchuk 2007; Bainbridge 2006). Some say the pay is too high and is set by captured boards while some say it reflects the marketplace in action. Therefore, some companies are either willing to or mandated to give shareholders an advisory vote on the prior year’s compensation of top executives-a “ say on pay (SOP).” SOP is a term used for a rule in corporate governance whereby stakeholders are given the opportunity to vote on the enumeration of executives. SOP potentially not only gives shareholders an advisory vote on pay practices, but also increases scrutiny from shareholders over top management’s compensation at most companies.

Therefore, this study illustrates how SOP improves pay for performance. Under certain circumstances, this study will show that pay for performance has been increasing significantly after the adoption of SOP. When further decomposing executive pay into its cash-based and equity-based components, this study finds evidence of an increase at most companies in the relationship between performance and these compensation components, and the potential to enhance transparency, governance, and accountability, which, in turn, should lead to greater efficiency and social responsiveness (Bebchuk, Friedman, and Friedman, 2007).

MAIN:

This study is going to discuss further about the principal of SOP and its effect on pay for performance in firms and the related principal-agency problems in corporate governance. SOP might have not been a new concept in corporate governance in the UK, but some firms in developed and developing countries have been implementing this concept over these years around the world. SOP is known as one of the recent phenomenon of shareholder activism, a “ voice” mechanism for shareholders (Hirschman, 1970). It is the effectuation of providing shareholders the right to vote on executive compensation program at the annual meeting. The regulation changes a variety of attitudes toward corporate governance and disclosure habitudes of all public companies.

This concept allows shareholders to either raise their voices or express their opinions against executive compensation programs. In other words, instead of letting top executives to decide the level of compensation plans, shareholders can use their voting rights to either approve or give advice on executive compensation plans that link to top executives’ performance. To clearly justify, SOP is seen as a friendly tool to express, improve the dissent, giving advice on remuneration, but not an aggressive governance rule to destroy firm value or dissociate the relationship between principal and agent. While companies are not bound by SOP advisory votes, the act not only requires firms to disclose the vote results after the shareholders’ meeting, but also report whether and how the board considers the voting results in the following year. Consistent with this argument, De Franco, Hope and Larocque (2013) find that additional disclosures improves board effectiveness at monitoring executive compensation and in strengthening the link between pay and performance.

SOP was used formally in UK in 2003, but in fact it was unofficially started and practiced in July 1999 as non-binding vote on executive compensation or remuneration. In the early of 2001, there are various companies beginning to propose the remuneration committee report, and there is an evidence that the number of firms submitting the proposal grew rapidly in 2002. After the UK, several EU countries consequently adopted this principle such as Netherlands, Norway, Sweden, then it spreaded to Australia and USA. It has been lasting for nearly 15 years in the UK while in the USA, this concept started in 2010 and became compulsory in the same year, which is relatively brief and the current knowledge of SOP’s results and effects are still limited along with many academic discussion and practices.

Basically, the objectives and models of SOP vary considerably across the world. Under Dodd-Frank, SOP in the USA requires companies to hold a non-binding vote on compensation at least once every three years. Afterwards, firms are also required to request shareholders to regulate the frequency of future say on pay votes at least once every six years but no less than that, also the shareholders are given the option of doing annually or every two or three years. However, in the UK, the government presented the Directors’ Remuneration report to record for a shareholder’s vote on current level of compensation at every annual general meeting.

Pay for performance is currently a big issue in corporate governance due to several executive compensation scandals. Additionally, House Report 110088 noted that the average of a CEO in a top company earned approximately 140 times higher than the pay of a regular employee in 1991; nonetheless, this ratio increased exponentially to about 500 to 1 in 2003. The compensation for CEOs is divided into 2 parts which are fixed compensation such as cash and bonuses, and variable compensation , also called performance-based compensation. The variable compensation which strongly relates to CEO’s performance, including option grants, stocks option,…. etc will be determined comprehensively in this study so as to favour the practical impact of SOP. Refer to Jensen and Meckling (1976), the traditional principal-agent theories stated that the owner of the firm constructed the compensation contracts to the agent in terms of maximizing the value of the firm. Muller-Kahle (2013) finds some evidence that, when CEOs have a dominant ownership stake, firm monitoring is diminished and firm performance suffers. However, most of public companies generates it infeasible for shareholders to debate the managerial compensation. In the phenomenon, the executive compensation scandals occurred frequently and severally than we could imagine. For examples, Tyco International was reported a CEO’s scandal in 2005, its CEO Dennis Kozlowski and CFO Mark H. Swartz were convicted of stealing $600 million, these money was symbolized as the excess of executive remuneration, i. e. Kozlowski gave his wife $2 million birthday gift on Islands Mediterranean at company’s expense. From our point of view, if Say on Pay was introduced and implemented earlier, those compensation scandals would had possibly not happened and also it’s reasonable to achieve and practice the SOP policy at the moment.

According to Vicente Cuñat, Mireia Gine, and Maria Guadalupe (2013), the main purposes of Say on Pay is to raising shareholders’ voices, concentrating on the shareholder’s interests but also focusing on values that CEOs added to the firm and the transparency of CEO’s interests. It leads to the improvement of the agency problem. Although a variety of evidence are against the benefits of Say on Pay, Bebchuk (2007) contended that a formalized say on pay vote is able to overcome the “ psychological barriers” and support the negotiation of better compensation contracts. Indeed, many articles suggest that the approach of SOP does have a positive correlation between both firms value and the issue of pay for performance.

We believe that there is nothing 100% right or wrong in all circumstances and it’s inherently difficult to determine precisely influences of any corporate governance regulation. Hence, the objective of this paper is to approve the improvements of Say on Pay on pay for performance in corporations in terms of increasing firms’ values, shareholders’ values, reducing agency problems and enhancing the transparency of executive compensation under certain conditions. First condition is firms with excessive or ineffectiveness CEO remuneration, as stated by Core at el. (1999), less effective boards are regularly related to high abnormal CEO compensation and low sensitivity pay for performance, which means that SOP is likely to benefit to the firm with weaker corporate governance and incompetent remuneration design. Secondly, firms with independent-minded shareholders willing to vote against management are likely to face more pressure if the say on pay is achieved; thirdly, firms are willing to boost performance, enhance compensation and reform as a consequence of shareholder pressure.

Due to Baird and Stowasser (2002), the first benefit of implementing SOP is certainly promoting accountability and transparency in the compensation report. To earn stakeholders’ support or prevent litigation, boards not only have sought to enhance disclosures concerning executive compensation plans but also publish an annual director’s remuneration report over the past year, which causes directors more carefully to consider shareholder interests when designing executive pay plans. The recent trend confirmed the increased directors accountability after the introduction of say on pay (Cai et al. 2007, 2009; Del Guercio et al. 2008). As found in the previous articles, Davis (2007) stated that the Say on Pay proposal did associate smoothly with the communication and relationship between shareholders and board of directors. Refer to the UK evidences, after annual general meeting and the accurately analysis of remuneration report, there is a substantially development in the connection and transmission between compensation committees and shareholders.

Firms are more opened to a dialogue with shareholders to justify a broader compensation decisions and practices. Companies will not only have the opportunity to include additional resolutions on specific compensation decisions, but also have the opportunity to ask shareholders’ views on specific compensation decisions, including decisions related to various aspects or categories of pay. Each company, however, will be required to permit shareholders to vote on a resolution addressing all of the compensation disclosed in the annual proxy.

This finding may advance scrutiny and also lead to more informed voting decision and the acceptance of a remarkable premium. Also, Deane (2007) and Davis (2007) suggested that SOP probably superior adjusts for principal-agent interests and enhance corporate governance and performance. The SOP allows shareholder to raise their voices in executive which definitely better align with CEO and shareholders interests, consequently, it comes up with the reduction of agency cost and a more adequately compensation contracts.

Due to Peter Iliev and Svetla Vitanova (2015), the market reacted positively to the practices of Say on pay votes and the general supports of directors from shareholders are spotted to be increased. In practices in the UK, the impact of SOP was found to be positive as well, Fabrizio and David A. Maber (2013) analysed that the adoption and implementation of say on pay to the UK regulation was escorted with positive stock price reactions at firms with high dissent compensation conflicts and particularly practices diluting punishment for poor performance.

By the same token, enforcing SOP may potentially increase Earnings per shares (EPSs), Return on assets (ROA) and Return on equity (ROE), the appliance also gains profitability and efficiency, higher growth in labour yield and constructive effect on accounting statement in the following years after the binding vote. As a result of Vicente Cuñat, Mireia Gine, and Maria Guadalupe (2013), the shareholder value increased by 5. 4 percent after Say on Pay implementation, this such high market gains were explained by the improvement of CEO’s performance under shareholder pressure and the effect of better alignment of pay for performance and also the reduction of pay for failure. Those evidences are consistent with the aims of this study that say on pay is used as a value-creating governance mechanism to contribute value to firm and shareholders.

According to Stephen Davis Millstein Center Fellow (2007), advisory Say on Pay votes are extensively seen as having been an influential committing factor in taming the rate of increase, reduce controversial compensation of CEO, pressure firm to increase sensitivity between compensation and performance curbing opportunities for ‘ reward for failure’ and tying compensation dramatically closer to performance. As we mentioned above, not every firms reported the same results on the impact of SOP. However, we do find the strong positive influence in the firm with high dissent between shareholders and directors and the firm with excessive CEO’s compensation based on the “ managerial power” viewpoint (Bertrand (2009), Frydman and Jenter (2010), Murphy (2013). As documented by Fabrizio and David A. Maber (2013), their tests were coherent with Core et al(1999) ‘ s research that the introduction of SOP was followed by positive stock price reaction, especially in the firms with controversial compensation report and those which abate penalties for poor performance. Correa and Lel (2013) also recorded a numerical decrease in CEO pay of 6. 1% after implementation of Say-on-Pay regulation in a sample of countries.

Moreover, by using regression analysis on large sample of UK firms, Fabrizio and David (2013) tested on some vital elements in CEO pays including bonuses, equity awards… to evaluate whether the sensitivity of CEO compensation is highly adequated to performance along with economics factors before and after the regulation. In general, they concluded that even though others economic elements persist unchanged, there is still a significant rise in the sensitivity of CEO pay to poor performance in less observable elements of pay. Moreover, this finding is consistent with the result of Ertimur, Muslu, and Ferri (2011) which is the most pronounced in high dissent firms and firms maintaining excessive executive compensation before SOP, means that SOP policy does reduce the excessive performanced-base salary to create value and link the remuneration more dramatically to the performance.

Various companies either removed or altered provisions that investors considered as “ rewards for failure” such as generous severance contracts and low performance hurdles, often in response to institutional investors’ explicit requests. Fabrizio and David A. Maber (2013) examined this issue on high dissent(HD) firm (with 20% dissent vote) and low dissent(LD) firm (with less than 5% dissent vote) before and after the vote , the result showed that the high dissent firms reducing the notice periods of severance contracts after the first vote (80%) are likely to be higher than before the vote (20%) and also substantially higher than the low dissent firms (33. 3%). Therefore, this figures suggested that say on pay is the reason of reduction of controversial compensation, besides, 70% of low dissent firms scaling down the notice period before the vote which is the evidence of elimination of dissension between shareholders and executives. Moreover, a variety of firms established a formal process for proactive consultation with their major shareholders going forward (Ferri and Maber, 2011). As a result, the threat of a vote was effective in inducing firms to revise CEO pay practices ahead of the annual meeting and decreasing the situation of pay for failures and the growth rate of pay.

Meanwhile, they also analysed the second most influenced remuneration item which is performance-based vesting conditions in equity grants. During the following years that performance targets are not accomplished, this retesting provision is seemed to contribute for reexamining and subsequently assists for the potential pay for failure. After the research, they concluded that before the first vote, HD firms and LD firms achieved 5% and 25% respectively to reduce or remove this issue. Nonetheless, the result changed significantly after the SOP vote, HD firms agreed to shorten or abolish retesting provision with statistically 76. 3%, while the LD gained 28%. Generally, several evidences support that these contractual modification are the direct repercussion of SOP regulation.

Base on the top 100 companies 2016 surveys in the US, SOP is raising shareholders’ voices and putting more pressure on CEO in order to perform better, however, we found that shareholder doesn’t empower themselves to manipulate the CEO’s compensation. In fact, the number of companies adopting this policy is increasing, in 2016 there are 95 over top 100 US companies holding say on pay vote in 2016, 94 out of 95 firms held approval say-on-pay votes which is higher than 2015 and only 1 firm didn’t approve which also failed in both 2014 and 2015. As being reported, 41 corporations reviewed and elected not to significantly change the compensation report, while 20 noted modification into the remuneration in response to the vote. In table 4, the Say on Pay approval rate in 2016 is relatively high with 78% receiving approval rates in excess of 90% and only 6% for-voting below 70%. This figures coordinate with data in the last 2 years 2014 and 2015, which the approval rates are comparably high. This finding suggests that the even shareholders have more control power in the firm, they are not likely to destroy the value or raise the unfairness and dissension through the firm. In contrast, they seem to use this policy as a friendly tool, not an aggressive regulation, to raise their voice and cut down excessive expense in compensation.

Furthermore, this regulation is contributing to the competitiveness of the British economy and the attraction of London as an international capital market (Stephen Davis Millstein Center Fellow, 2007). The UK Department of Trade and Industry confirmed that the votes lead to “ a better planning by corporations, fewer surprises, better dialogue with shareholders”, and apparently, it can reduce downside risks and big scandals among quoted companies in recent years. Due to London Stock Exchange, by involving Say on Pay voting rights, London will possibly be equipped with a more competitive border in order to attract capital, comparing to New York.

Last but not least, while companies are not bound by SOP advisory votes, it requires companies to disclose the vote results after the shareholders’ meeting. In addition, firms must report whether and how the board considers the voting results in the following year. Ferri and Maber (2013) study the market reaction in 2002 to SOP that mandates non-binding but advisory vote on the compensation report and find that firms with high dissent alter the compensation composition, thereby improving pay for performance. Moreover, in a sample of the largest UK companies from 2002 to 2006, boards reduced excess salary as well as the dilutive effect of stock option grants in response to past negative non-binding votes (Carter and Zamora, 2009). Consequently, shareholders’ right of non-binding votes could provide a useful mechanism that addresses the potential problem of incomplete firms’ management, suggesting that monitoring and reward mechanism dynamics can effectively coexist between owners and firm managers, thereby improving corporate governance (Kimbro and Xu, 2016).

Conclusion

To conclude, we investigate the impact of the right of shareholders’ non-binding but advisory votes on say-on-pay. We find evidence that firms either modified or altered their compensation structures in order to win shareholders’ positive votes. CEOs’ compensation decreases in most firms while larger decreases are found in firms that overpaid their CEOs in the previous year. Similarly, affected firms linked their pay mix to more close for performance. In terms of voting itself, shareholders are not more likely to vote for executive compensation when the firm pays excessive pay for top management, or has a large increase in CEO compensation compared to previous years. Moreover, among the components of the compensation plan, shareholders are more likely to vote against the plan when they contain “ other compensation”, such as private bonuses unrelated to performance, which have been opposed by critics of executive pay. Most importantly, SOP does not limit the level of compensation or empower shareholders to control the interests of top management. It can be seen as a friendly corporate governance tool to prevent conflicts of the issues between top management and shareholders regarding pay for performance.

Additionally, this study finds that the increase in pay for performance after the implementation of SOP is larger in firms with excessive pay for CEO relative to firms with average level of pay for CEO. The evidence suggests that SOP do increase the executive compensation monitoring ability for investors who care about the long-term value of a firm but who are lack of the ability to influence executive compensation structure before SOP. By contrast to most prior studies on the impact of SOP on executive incentives and compensation, the evidence shown in this study is consistent with SOP improves rather than weakens the alignment of managerial wealth and shareholder interests in certain circumstances.

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